CAPITAL MARKETS DEREGULATION AND LIBERALIZATION ACT OF 1995

ARINGS

BEFORE THE

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

OF THE

COMMITTEE ON COMMERCE
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

ON

H.R. 2131

NOVEMBER 14, NOVEMBER 30, AND DECEMBER 5, 1995

Serial No. 104–50

Printed for the use of the Committee on Commerce

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CAPITAL MARKETS DEREGULATION AND LIBERALIZATION ACT OF 1995

TUESDAY, NOVEMBER 14, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON COMMERCE,
SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2123, Rayburn House Office Building, Hon. Jack Fields (chairman) presiding.

Members present: Representatives Fields, Oxley, Cox, Frisa, White, Markey, Furse, Eshoo, Klink, Richardson, and Dingell (ex officio).

Staff present: David L. Cavicke and Linda Dallas Rich, majority counsel; Brian McCullough, professional staff member; and Deirdre McCullough, clerk.

Mr. FIELDS. By previous agreement, the chairman will recognize himself for 10 minutes and the gentleman from Massachusetts for 10 minutes for the purpose of an opening statement and all other members will be recognized for the customary 5 minutes.

Today this subcommittee embarks on an historic effort to examine and analyze our Nation's securities laws. This is the first major reform effort of its kind since the securities laws were enacted in the 1930's and I think that it's important to point out that these laws have served our country well. Our markets are the envy of the world, both because the markets are transparent and because we have a strong system of investor protection.

And in this historic effort, market transparency and investor protection is not on the table for discussion, but unnecessary and duplicative rules, regulations and laws are, whether they are on a State, an SRO or Federal level.

But during this process I am not looking for reform strictly for reform's sake. The Speaker has asked that those of us in positions of responsibility put all aspects of our jurisdiction under the microscope, and we're doing that with the other half of our jurisdiction—telecommunications. And we will send an historic piece of legislation to the President prior to the Christmas break.

And, as most of you know, it's that jurisdiction, telecommunications, which normally consumes most of our subcommittee's time and energy. This year, however, I felt it incumbent upon us to dust off the 1933, 1934 and 1940 Acts and so I introduced "The Capital Markets Deregulation and Liberalization Act of 1995" during the last week of July.

My goal was to initiate a national debate on our securities laws, both State and Federal, and to do so, as I thought we were nearing the end of telecommunication reform, so that everyone would have plenty of time to comment and State opinions. And I've already heard a number of comments and statements about the legislation, some good, some bad, but almost total unanimity that our securities laws should be examined after 50-plus years and that there has already been dramatic change since the Capital Markets bill was enacted in July.

I think it is important to know that the Capital Markets bill has done more than just trigger a debate. As an example, No. 1, the SEC has announced a top to bottom review of the SEC's regulations to see which ones are now outdated and/or counterproductive. This entails over 300 existing regulations and more than 100 forms.

Second, there's been a dramatic shift in the SEC's position on margin reform. Prior to introduction of the Capital Markets bill, the SEC was cool to the idea of margin reform. Now the SEC has proposed to eliminate a substantial portion of its margin rules.

Third, Chairman Levitt has proposed that the States, SROs and the SEC coordinate inspection of broker-dealers.

Fourth, Chairman Levitt has announced a proposal to allow for the electronic delivery of a prospectus.

Each one of these reforms at the Commission relates to a separate provision in the Capital Markets bill. It could be that these developments are merely coincidental or that Federal regulators have responded to our legislation. And for that I applaud Chairman Levitt.

It's also important to note that the North American State Securities Administrators have created a blue ribbon panel to examine the respective roles of the States and the Federal Government in securities regulation, again patterning after a specific provision in our legislation. And I will hasten to add that I look forward to hearing from NASSA and working with them.

Today begins the first of three hearings. On November 30, the subcommittee will hear from SEC Chairman Arthur Levitt and Federal Reserve Chairman Alan Greenspan. On December 5 the subcommittee will hear from the SIA, PSA, ABA, ICI and NASSA; in other words, acronym day. And we will also hear from consumer groups.

I look forward to these hearings and the testimonies that we will receive. We will search out answers for questions such as: Is suitability inappropriately raised by institutional investors when a bad investment decision is made? Should a national securities market be created similar to the Euro market? Should margin rules be liberalized and then harmonized between banks and broker-dealers? Should there be reform in the prospectus area?

I look forward to not only finding answers to questions like these but also to clear up misconceptions and misrepresentations about this piece of legislation. As an example, the Capital Markets proposal does not repeal the Williams Act. Rather, it streamlines disclosure under 30(g), making disclosure requirements apply quarterly and leaves in place the William Act anti-fraud provisions. The

Capital Markets bill leaves in place the ability of the SEC to adopt rules governing tender offers.

I'm excited about these hearings. I fully intend to mark this legislation up at the subcommittee and the full committee and take the Capital Markets bill to the floor. This legislation is a work in progress. During this process parts of the legislation may be deleted or modified, and good ideas that we hear in our testimony may be added to the legislation.

And while I introduced the Capital Markets bill prior to the August recess for the purpose of initiating a debate on our securities laws, it was not my intent to exclude my friends on the other side of the aisle. My good friend from Massachusetts has played a vital role in the area of securities law and it is my hope that we can work together to further investor protection, capital formation and market efficiency while, at the same time, ferreting out duplicitous and unnecessary rules, regulations and forms.

That concludes the statement of the Chair. The Chair will now recognize the vice-chairman of the subcommittee, Mr. Oxley, for 5 minutes.

Mr. OXLEY. Thank you, Mr. Chairman, and I commend you for your leadership on this very important issue. This morning's hearing on capital markets deregulation begins an overdue reassessment of a system of regulations set up in the 1930's. I welcome this opportunity to review the Nation's securities laws. Indeed, as a cosponsor of your bill, I'm persuaded of the need for a comprehensive overhaul.

This effort is about more than reducing paperwork and red tape, although these are worthy goals in and of themselves. The reality is that these regulatory burdens impose real economic costs on the Nation by impeding capital formation and, in turn, job creation.

I, as you know, Mr. Chairman, recently had a town hall meeting with Chairman Levitt in Columbus, where we had over 1,000 people attend, showing a great interest in capital formation and markets. I think it was one of the best opportunities I've had to interact with real citizens about the importance of capital markets.

I commend you for putting together an excellent package of reforms. I'm looking forward to hearing from some of the experts in the field today. I anticipate future testimony from Administration officials and other industry representatives, and I yield back the balance of my time.

Mr. FIELDS. The Chair will now recognize the gentleman from Massachusetts, the distinguished ranking minority member, for 10 minutes.

Mr. MARKEY. I thank the chairman very much and I must confess some mixed feelings at the moment, Mr. Chairman. I am very pleased that you have brought us together to discuss an exceptionally important long-term issue of great significance to virtually all working Americans.

That issue is on the table because of your leadership and because of the hard work and the long hours that you and your staff have devoted to studying it. The issue is how to maintain the status of American capital markets as the fairest, most successful and most liquid that the world has ever known.

It should be noted for the record that the subcommittee is also meeting at an awkward time, given that we are faced with a profound short-term crisis, and paradoxically, the harm that could be done to our capital markets by this crisis far exceeds the help that would be provided to them were we to enact any or even all of the proposals and ideas that will be discussed here today, assuming, of course, that all of these ideas would be helpful.

But without belaboring the point, I believe it is regrettable that the American government's creditworthiness is being jeopardized by being linked to a controversial and partisan set of issues.

Notwithstanding the paradox, however, we begin our review with an accomplished panel of witnesses and I look forward to hearing from them. I also look forward to working with you, Mr. Chairman, as we plan additional hearings to bring in a range of other experts and interested parties to develop the fullest possible factual record on the various needs of the marketplace.

The logical starting point for our review should be an assessment of the health of the market itself. And on this score, all indications are that the news is quite good. By virtually every statistical measure, our capital markets are vibrant and healthy. For example, in 1994, for the third consequence year, companies raised $1 trillion in capital from investors in American financial markets, smashing all previous records. Indications are that 1995 will be even more successful.

Those who follow the stock tickers also know what kind of year it has been. Yesterday marked the 218th trading day of the year on our stock markets. On 40 occasions the American Stock Exchange closed at a new record high. On 56 occasions the Dow-Jones Industrial Average closed at a record high. And on 66 occasions the NASDAQ closed on a record high.

The stock market is not the only thing setting records. We are in the midst of the greatest merger and acquisition boom in history. The value of mergers exceeds even the levels in the mid–1980's and has been accomplished without the perilous debt levels and speculative frenzy that so often characterized take-overs in that era.

With 6 weeks to go, approximately $400 billion in mergers of U.S. companies has already been announced, shattering the record set just last year.

Overall, the stock markets are in the midst of the longest run in this century, now about 5 years, without a 10 percent drop. This has been an unprecedented boom for companies, investors and Wall Street firms.

With all this good news, it should come as no surprise that Wall Street's profits are expected to set new records for the second time in the last 3 years.

This is just a small sample of the data that can be put forward to demonstrate the vitality that presently characterizes our financial markets and that serve to make them the envy of the world. While this unprecedented streak can't last forever, it is against this successful backdrop that we should evaluate proposals for reform and renewal such as those contained in H.R. 2131.

As I have said many times before, even healthy patients need periodic check-ups. But the statistics do suggest that our exam

need not and should not be conducted under the extreme procedures and pressures appropriate only in an emergency room. Our past success gives us the opportunity to consult widely and deliberately so that carefully, before deciding upon a course of action, we will have listened to all points of view.

Mr. Chairman, not all observers are willing to acknowledge the health of the market. Indeed they clamor for radical changes by referring to Depression-era investor protection, contemptuously, and disclosure laws, as if the fact of their birthdates somehow conclusively proves that the laws are archaic and unnecessary. By this logic, however, the Ten Commandments and the Bill of Rights have long since outlived their usefulness.

These critics have apparently washed away memories of the catastrophic economic and market conditions that gave rise to our securities laws. They disregard the fact that between 1929 and 1932 the value of all stocks listed on the New York Stock Exchange shrank by 83 percent and that half of all the stocks sold to investors from 1920 to 1933 turned out to be totally worthless.

And they dismiss the writings memorialized by Ferdinand Pecorra, the legendary counsel to the Senate Banking Committee. Pecorra wrote of a shocking corruption of our banking system and a widespread repudiation of old-fashioned standards of honesty and fair dealing in the creation and sale of securities.

With foresight that would impress Nostradamus, Pecorra said he wrote to remind the public what Wall Street was like before Uncle Sam stationed a policeman at its corner, lest in time to come some attempt be made to abolish the post.

Mr. Chairman, H.R. 2131 represents the first attempt in many years to identify the issues that should be included in a comprehensive effort to renew and reinvigorate our regulation of capital markets. I welcome your invitation to work with you as this effort evolves.

There are several provisions of H.R. 2131 which I am pleased to support, including its effort to boost the capital-raising abilities of small businesses and the grant of additional exemptive authority to the Securities and Exchange Commission.

I also support the goal of eliminating duplicative and overlapping regulations which do not provide any additional protections to investors or to the markets but which do serve to increase costs.

As you know, however, I do take a different view on some of the other provisions in the bill. For example, with regard to the Williams Act, rather than repealing most of its important requirements, I would suggest tightening them up. In this age of instant communications, the 10-day reporting window opened by the act when an investor gets a 5 percent stake in a company should be closed to 48 or 72 hours.

With regard to the complex issue of suitability, I understand the desire of the broker-dealer community for greater certainty with regard to the nature of their obligations to their institutional clients, but it is not clear to me why the recently promulgated NASD rule on suitability fails to respond to this concern.

Perhaps more importantly, I do not understand why so many recent discussions of suitability have focussed exclusively on the re-

sponsibilities of the client while ignoring entirely any professional ethical obligations on the part of brokers.

And finally, our dual system of State and Federal regulation seems to provoke consternation among some critics while leading others to hyperbole and exaggeration. The fact is that for most issuers, the dual regulatory system is largely irrelevant. If you're one of the thousands of companies listed on the New York Stock Exchange, the American Stock Exchange or the NASDAQ's National Market System, you are entirely exempt from any independent State registration requirement. I have no doubt that we will be hearing a lot more about this issue.

I am hopeful, however, that our discussions of it will separate facts from fiction so that we can focus on how to improve the allocation and coordination of State and Federal regulation without losing any of the vital protections that both provide.

I've addressed a number of issues raised by the legislation, Mr. Chairman. Let me briefly identify some additional issues that may also deserve to be examined. The first issue is familiar to subcommittee veterans. Twice in the last 4 years we sent to the House floor bipartisan legislation to thoroughly revamp our regulation of investment advisers and financial planners. On both occasions, the legislation passed the House on suspension, only to get bottled up in the Senate. This legislation is badly needed and long overdue and we should take it up promptly as part of this review.

It also seems to me that a logical adjunct of the proposal to increase the responsibilities of institutional investors would be to finally recognize their rights. We should consider giving institutional investors the right to nominate their own candidates for election to corporate boards and to allow those names to appear on a unified proxy ballot. Our failure to do so is the rough equivalent of saying that young people are mature enough to defend the country but not mature enough to vote in the country's elections.

We should also consider whether legislation is needed to address the problems of sales practice abuses and rogue brokers. A significant report on this subject was produced by a blue ribbon commission appointed by SEC Chairman Levitt, but with some notable exceptions, it appears that most firms have chosen not to implement its nonbinding recommendations.

Market 2000 issues might also be addressed in this legislation.

Mr. FRISA. Excuse me, Mr. Chairman. Would the gentleman like to request unanimous consent for additional time?

Mr. MARKEY. Mr. Chairman, I did not know my time expired.

Mr. FIELDS. The Chair was being accommodating. The gentleman can complete his statement.

Mr. MARKEY. I thank the gentleman very much. I only have three additional paragraphs.

Market 2000 issues might also be addressed in this legislation. In recent months both the SEC and the Justice Department have launched major investigations into allegedly improper practices on the NASDAQ market while the NASD has itself opposed a major structural reorganization.

In light of these developments, we could review trading practices in the NASDAQ market with an eye toward determining how to improve investor protections in the dealer market.

This is not a comprehensive list, Mr. Chairman. Nor is it necessarily a list of the most important new issues we should take up. For example, at SEC Commissioner Steve Waldman is directing a review of the benefits of shifting the securities laws toward a company registration model.

Let me close, Mr. Chairman, by again thanking you for undertaking this review of the health of the capital markets. I am confident that all of the subcommittee's Democratic members will welcome your invitation to work in the bipartisan spirit that has characterized so much of our work in the past recent years.

We, in turn, promise to work with you constructively and expeditiously to produce a review that is fair and comprehensive and balanced and responsive to the evolving needs of investors and the market as a whole. We have worked together on many of these issues in the past, Mr. Chairman. Your working cooperative spirit is one that I'm sure is going to animate this work. It has done so in the telecommunications bill that we're now considering. I'm sure that the same will be true for this legislation, as well.

I thank you for calling this hearing and I yield back the balance of my time.

Mr. FIELDS. The gentleman's time has expired. The Chair wanted to hear all those nice things that the gentleman from Massachusetts was going to say.

The Chair will now recognize the gentleman from New York. And let me point out how much I appreciate the extra hours the gentleman has put in examining issues relative to the Securities and Exchange Commission, and the Chair is very appreciative of that.

The gentleman is recognized for 5 minutes.

Mr. FRISA. I thank the chairman, and thank you for your recognition. And I'd like to acknowledge for the record the tremendous leadership, Mr. Chairman, that you've provided on this issue. It certainly hasn't been a totally positive experience for yourself and for those of us who have cosponsored the legislation, but I think the reaction that this bill has engendered is very positive in itself because we're now discussing the issues.

We now have the issues on the table. And I think for the first time in quite a long time, we'll be able to examine them rationally, thoughtfully, with expert input, certainly today and in our two subsequent hearings, so that we may properly address reforms that may very well be needed.

And as you mentioned, I'd like to underscore our philosophy that our goal should be to ensure continued investor confidence—that is our first and foremost aim—and, at the same time, to encourage an even more successful formulation of capital. And I think the success of the markets, and yesterday once again the Dow hit an all-time record high, I think is a positive sign, but that should not keep us from our important work, to review those areas that require reform and revision.

And in line with several of the provisions of the legislation, we have been working diligently on a report on the EDGAR system, which is now in draft form and which will be finalized shortly, and then made available to the public with some recommendations and an overview of the EDGAR system and prospects for privatization, as well as working with the chairman, the staff, as well as Chair-

man Levitt and folks at the SEC in terms of reviewing regulations, which is very important.

I had the opportunity, Mr. Chairman, to attend a conference with the National Society of Compliance Professionals just 4 weeks ago and received these two volumes of just the outline of their workshops for the day. So there are literally thousands and thousands and thousands of pages of rules and regulations that are confusing, sometimes in conflict, and it's with that thought that we'd like to approach a rational review of them, to make them more logical, rational and more easy to comply with for the sake of disclosure and for filing requirements.

I look forward to the hearings and thank the chairman for his leadership and look forward to working with him and members on both sides of the aisle and the panel. I yield back.

Mr. FIELDS. The Chair thanks the gentleman for his hard work and the Chair will now recognize the gentleman from Pennsylvania, Mr. Klink.

Mr. KLINK. I thank the chairman. Just let me start off by saying I'm pleased with the tone of some of the opening statements that we've heard here this morning, and this is the subcommittee that we know and love when we can get together and try to work out some of these things.

I've said to some of my colleagues before I think, just as I did with the securities litigation bill, that H.R. 2131, as written, was going too far, too fast, and appeared to be very partisan to fix some problems that may or may not exist.

I am glad that there are going to be changes to this legislation. I'm hopeful it can be done in a bipartisan fashion, and from the sound of what I'm hearing this morning, I believe that it can be, as is always the best case.

H.R. 2131 was really drafted without input from the minority, its development and very existence denied by majority staff. The bill has been criticized by former Republican appointees to the Securities and Exchange Commission, consumer groups, State regulators and local finance officials.

I'd just like to say I've been contacted by the chairman of the Pennsylvania Securities Commission, Robert Lam. Mr. Lam characterized the bill as ill-advised legislation that he said would have severe adverse effects on Pennsylvania investors and businesses.

Our former colleague Tom Ridge, who was a good member in the House of Representatives and our current Republican Governor, has also expressed his concerns about this bill and the impact that he thinks it would have, as written, on the Commonwealth of Pennsylvania.

I am pleased now that we're having a very much needed hearing on the bill. Mr. Chairman, I certainly do not want to pile onto my friend. I'm aware that this bill has been given rather severe treatment by the Los Angeles Times, by Money Magazine and others, and I welcome your statements—I know they come from your heart—when you say that this bill is designed to begin debate, and it will do that.

Your work—you say you will continue to work with the States and this bill is subject to change, and I know from your past record in chairing this committee that you indeed mean that. You've

worked with the members very fairly and very graciously and you've tried to accommodate us.

Having said that, I still have serious reservations about the legislation as drafted. I believe it's going to endanger the health and safety of our financial markets and weaken laws that protect investors and primarily the Mom and Pop investors.

I agree with Mr. Markey that there are some good things about this bill and I won't belabor what some of those things are. H.R. 2131, as drafted, is a problem, violating States' rights by preempting State securities laws. It will eliminate the requirement that brokers make only suitable recommendations to their institutional clients.

Furthermore, the legislation will eliminate the requirement for timely disclosure of key information about potential corporate takeovers, something that we've seen our fair share of in my region of Pennsylvania and the Tri-State area.

H.R. 2131 will also severely limit the SEC's ability to police the market. I am happy to hear the chairman say that we're going to have more hearings. I think that these hearings are needed for all of us who are on the committee and want to work our way through these and see that something good can happen to the financial markets.

I would also like to hear from State regulators and would suggest to the chairman and the majority staff that Pennsylvania's Securities Commission Chairman Robert Lam would be an excellent witness if you can find time for him.

Mr. Chairman, changes in our securities laws of the magnitude of those in the bill require careful consideration to ensure that investor protection occurs and to avoid disruption of the finest capital markets in the world, and make no doubt about it that they are.

I hope that we'll take the time to deliberate and to think about this and talk about this in the manner that we should and I feel, after hearing the comments this morning, I feel definite that we will. Thank you very much. I yield back my time.

Mr. FIELDS. The Chair thanks the gentleman.

The gentleman from Washington State, Mr. White.

Mr. WHITE. Thank you, Mr. Chairman. I appreciate it very much and I'm very happy to be here this morning.

Mr. Chairman, as I think you know, as I hope you know, I represent the First District of Washington State and with only a little bit of hyperbole, we like to think of our district as the commercial center of the Northwest United States.

We have many large companies there and, perhaps more important, we have hundreds and hundreds of small companies, most of whom are located in my district, in the biotech, the high-tech, software and other industries, all of whom depend on healthy capital markets to grow and prosper and provide jobs and prosperity for our area of the country and for the country as a whole.

So this is a bill that we're considering this morning that's very dear to my heart and to the hearts of my constituents, and I congratulate you for holding this hearing and bringing this bill forward.

Mr. Chairman, you've probably also know, and I know my time hasn't really expired—thank you very much for changing the light.

As you may also know, about 11 months ago I was a partner in Seattle's largest law firm. I was in the business department of our law firm and I had the opportunity to dabble, from time to time, in securities law.

Now, that might give some of my former clients some pause, the fact that I dabbled in it, because it's a very complicated area. And I'd have to say that my real knowledge of this area comes less from dabbling in it myself, although I did do some of that, than from the fact that my office was located just a few offices down the hall from the securities lawyers in my firm, and our firm probably had one of the most active security practices in the State of Washington.

And I remember very, very well those occasions, and it happened every month or so, when a big prospectus was going out or another big project was under way, and I can remember the securities lawyers and their paralegals and the secretaries at the firm and the clients tearing their hair out over some of the requirements imposed by the securities laws in trying to raise money from the capital markets.

And the lesson I learned from that or the conclusion I drew from that is not that we have to make life easy for lawyers—that's about the last thing we need to do—but I do think that this is an area where reforms are possible and there are probably some reforms that can be made here that would improve the systems not only for lawyers but for all of us and would bring the rules that we have to follow in the securities area up to date and take advantage of some of the recent changes in the marketplace and in the commercial world in general.

So I'm happy that we've brought this bill forward. I think it's very much in keeping with the sort of reform efforts we've taken in other areas during this Congress to look at all the laws that are out there and try to make sure that we're getting the more efficient and productive rules that will apply to various parts of our society.

So once again, Mr. Chairman, I'd like to congratulate you for bringing this bill forward. I'm proud to be a cosponsor of it. Like you, I view this bill as a work in progress. There are probably some parts of this bill, as we listen to the witnesses, we'll decide that maybe can be improved, and I'm certainly openminded and willing to do that.

But I think what we're doing here is important work and I'm proud to be a part of it and I yield back the balance of my time.

Mr. FIELDS. The gentleman yields back. The gentlelady from California, Ms. Eshoo.

Ms. ESHOO. I don't have any opening statement, Mr. Chairman. I look forward to working with you. I agree with my colleague from the State of Washington that this is a work in progress and work we must. I think that this has a ways to go.

So thank you and I look forward to doing that and I thank the witnesses for being here. Is it my understanding that we're going to have further hearings on this and that the chairman of the SEC will be invited in to testify?

Mr. FIELDS. The gentlelady is correct.

Ms. ESHOO. Thank you very much.

Mr. FIELDS. The gentleman from California, Mr. Cox.

Mr. CHRISTOPHER COX. I thank the chairman. I want to extend my welcome to the very distinguished panel of witnesses from whom we will shortly hear.

The subject of today's hearing, improving and expanding access to our capital markets and reducing the cost of capital, is especially important for job creation and for the continued health of our economy.

One of the best ways that we can reduce the cost of regulation, as a component of the cost of capital, is to eliminate unnecessary regulations and duplicative regulations. I can think of no more fertile ground for an investigation into duplicative regulations than the regime of State blue sky laws.

I hope that our hearings will simultaneously spur NASAA to investigate the merits of merit review. In many respects, simultaneous analysis of the price of a proposed public offering by regulators at the State level and by the capital markets themselves operates as nothing more than a thinly veiled disguise for a revenue-raising device at the State level.

I am interested to hear people express concern about States' rights in this regard when, in fact, as we all know, these State regimes of regulation antedate the Federal securities laws and certainly antedate the development of what is a national market system in our own country and, more than anything, a global market.

Net capital inflows into the equity markets of developing countries increased by a stunning factor of over 50 in the last 5 years. Over the last two decades, in the face of increased competition, United States' share in world equity market capitalization has been cut in half.

There is no question that we are in a global capital market. To look at this as anything other than a national regulatory system is to miss the point entirely.

I've always thought that as Congress expanded Federal authority into so many areas of our lives under the guise of the interstate commerce clause, it was ironic that the one thing that Congress sees unfit to regulate at the national level is interstate commerce or, in this case, international commerce.

I am also pleased that this panel and our subsequent witnesses will take a look at issues such as the privatization of EDGAR because one of the big changes in the world over the last many decades is not only the globalization of capital markets but also the development of computer technology and the possibility of simultaneous transmission of information by many, many players in our capital markets.

And I'm pleased that we will look at the issue of clarification of the SEC's exemptive authority. I hope, in fact, that we will make more sturdy, through statute, the Commission's ability to issue clear exemptions where they are so richly needed.

One of the additional changes that has grown up in our marketplace in recent decades is the significant influence of institutional investors, who must be treated differently than the Mom and Pop investors, about whom concern was expressed just a moment ago.

In all of these respects, we are wise to take a look at our regulatory system and ask ourselves whether it's going to meet the

challenges of the 21st Century as well as it has met the challenges of the 20th Century.

I thank the chairman and look forward to the testimony of our witnesses.

Mr. FIELDS. The gentleman yields back.

The Chair sees no other member seeking recognition for the purpose of offering an opening statement, the Chair would now like to turn to Dr. Charles Cox, economist, chief executive officer at Lexecon. Dr. Cox was a former SEC chief economist. He was a commissioner at the SEC and also served a period as the acting chairman of the Securities and Exchange Commission.

Dr. Cox, we'll recognize you for 5 minutes. We will put any matter that you wish in the record if you should exceed your 5 minutes, but we would like for you to stay as close as you could to the 5-minute time limit. Thank you.

STATEMENTS OF CHARLES COX, SENIOR VICE PRESIDENT, LEXECON, INC.; J. CARTER BEESE, JR., CHAIRMAN, CAPITAL MARKETS REGULATORY REFORM PROJECT, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES; SAUL S. COHEN, ESQUIRE, ROSENMAN & COLIN, LLP; PROFESSOR JOHN C. COFFEE, JR., ADOLPHE BERLE PROFESSOR OF LAW, COLUMBIA UNIVERSITY; AND A.A. SOMMER, JR., MORGAN, LEWIS & BOCKIUS, LLP

Mr. CHARLES COX. Thank you, Chairman Fields and members of the subcommittee. I appreciate the opportunity to testify before the subcommittee on the subject of the Capital Markets bill and I request that my written statement delivered to the subcommittee earlier be included in the record.

I served from 1983 to 1989 as commissioner of the Securities and Exchange Commission. During 1987 I was acting chairman of the Commission. From 1982 to 1983 I was the Commission's chief economist.

Since 1989 I've been senior vice president of Lexecon, Inc., a Chicago consulting firm that specializes in the application of economics to a variety of legal and regulatory matters. I have a Ph.D. in economics and my research focusses on financial markets.

From my experience, I believe that I have considerable expertise on securities regulation, capital markets and shareholder protection to offer the subcommittee. My experience leads me to conclude that there are areas where regulation of the U.S. securities markets can be improved. The securities laws function as a framework in which market participants can invest with confidence. So those laws are an important component of the capital markets infrastructure.

Nevertheless, some areas burden and impede capital formation, competition and market efficiency, without offsetting benefits of investor protection. Consequently, I support H.R. 2131. It allows diversity and change in some areas where legally imposed similarity is counterproductive. It removes overlapping regulation that is costly but is not protecting investors. It relies on market forces where appropriate yet it maintains strong protections against fraud.

I comment particularly about my support for six provisions of H.R. 2131. First, setting a national standard for registering securi-

ties recognizes that the securities markets are national and that State registration requirements are an unnecessary burden on raising capital that adds little, if any, investor protection.

Second, modifying several sections of the Williams Act removes a burden on competition that functions to redistribute wealth rather than protect against fraud.

Third, privatizing EDGAR subjects it to a market test of whether users' value of electronic access to SEC filings is as great as the cost. And privatization would facilitate more rapid introduction of advances in technology.

Fourth, clarifying the suitability responsibility of broker-dealers to institutional investors would decrease trading costs without preventing institutions from contracting for suitability duties if they so desire. Moreover, this provision is consistent with the Commission's recognition that institutions are sophisticated investors.

Fifth, directing the SEC to consider the effects of its actions on capital formation, competition and efficiency makes sense because it is impossible to regulate the securities markets without affecting these factors.

Sixth and finally, clarifying the SEC's exemptive authority enables to Commission to respond more efficiently to shifting needs of securities regulations as markets develop. However, the Commission's strong exemptive authority should apply across all of the laws that it administers.

In conclusion, the reforms in H.R. 2131 would better balance the costs and benefits of securities regulation. They would reduce burdens on capital formation, competition and efficiency without undercutting investors' protection against fraud.

At this point, Mr. Chairman, I'd be pleased to answer any questions that members of the subcommittee may have. Thank you.

[The prepared statement of Charles Cox follows:]

Prepared Statement of Charles C. Cox, Senior Vice President, Lexecon Inc.

Introduction

Chairman Fields and Members of the Subcommittee: I appreciate this opportunity to testify before the Subcommittee on the subject of the Capital Markets Deregulation and Liberalization Act of 1995. I served from 1987 to 1989 as Commissioner of the Securities and Exchange Commission. During 1987, I was Acting Chairman of the Commission. From 1982 to 1983, I was the Commission's Chief Economist. Since 1989, I have been Senior Vice President of Lexecon Inc., a Chicago consulting firm that specializes in the application of economics to a variety of legal and regulatory matters.

During my service as Commissioner, I testified to this Committee about ways that the Commission could protect the integrity and sound operation of the nation's securities markets to benefit investors, facilitate capital formation, and promote market efficiency. That testimony usually covered particular rule proposals or enforcement matters. Today, I intend to testify about the same goals—investor protection, capital formation, and market efficiency—but in terms of H.R. 2131, the Capital Markets Bill being considered by this Subcommittee. I support H.R. 2131. In my opinion, based on seven years experience as an insider at the Commission plus six subsequent years studying various securities markets' topics, H.R. 2131 would benefit investors by removing burdensome regulations without decreasing protections against fraud.

It is unrealistic to think that a certain set of securities laws and SEC policies would produce a major increase in capital formation or efficiency of the securities markets. Capital formation is determined principally by economic conditions both nationally and internationally. Market efficiency is determined principally by developments in information and financial technology. Nevertheless, the securities laws

and the SEC's efforts to interpret and enforce those laws influence both capital formation and market efficiency by producing a framework in which market participants can invest with confidence and by imposing costs that would not otherwise exist. So government efforts to increase economic growth should consider how the securities laws and SEC regulatory policies affect capital formation, market efficiency, and competition. In my view, investor protection properly interpreted is consistent with promoting both capital formation and market efficiency. Indeed, efficient, competitive securities markets are probably the most important protection that investors have.

In brief, my advice is that the federal securities laws should accommodate and encourage competition, change, and diversity in the securities markets while maintaining protections against fraud. This approach is consistent with the securities laws' goal of investor protection and it promotes additional capital formation and market efficiency. This approach uses market forces whenever it is possible and appropriate. H.R. 2131 generally takes this approach. In contrast, areas in which the securities laws impose similarity—a "one size fits all" approach—and maintain the status quo tend to stifle efficiency and capital formation without adding much, if any, investor protection. There are other areas of the securities laws that no longer serve useful purposes in today's securities markets. In these areas, H.R. 2131 offers judicious pruning of rules that would promote capital formation and market efficiency while maintaining investor protection. In the following sections, I comment specifically on several provisions of H.R. 2131.

NATIONAL SECURITIES MARKETS

I support the provisions of H.R. 2131 that remove burdensome, overlapping state registration requirements for issuers and broker-dealers. The securities market have long been national markets and are now becoming international markets. State blue-sky laws in addition to SEC registration requirements are a prime example of duplicative regulation that increases the costs of raising capital without generating offsetting benefits.

I have seen no evidence that state registration requirements generally benefit investors. Discussions about states' merit regulations for issuing securities are usually in terms of anecdotes. Proponents of merit regulation cite one or two examples in which a state's investors were "protected" because they were unable to purchase securities offered by a "meritless" issuer whose business subsequently failed. Opponents of merit regulation cite one or two examples in which a state's investors were harmed because they were unable to purchase securities offered by a "meritless" issuer whose business subsequently became a stunning success. These anecdotal debates show only that regulators have no better insight into an issuer's business prospects than public investors who have the opportunity to benefit from the SEC's full disclosure approach to regulating new issues of securities. Moreover, merit regulators have much less incentive to evaluate companies than investors who are putting their money where their mouths are. On the other hand, the success of the U.S. securities markets under the federal securities laws' full disclosure approach to securities regulation shows overwhelmingly the superiority of disclosure to merit regulation.

Where state registration regulations have been streamlined to coordinate SEC registration requirements, the state regulation is merely duplicative of federal regulation. The state regulation then serves as a "tax" on issuing new securities the benefits of which go to securities lawyers in the form of fees and to regulatory personnel in the form of power and larger organizations.

In my experience, the state securities regulatory organizations and their associations have been reluctant to cooperate with the SEC when it has attempted to lower the costs of issuing securities by reducing registration requirements. Put simply, regulators rarely cede control voluntarily. For example, the SEC proposed a uniform limited offering exemption to reduce the costs of public offerings for small companies, but negotiations with the states dragged on for years. Consequently, I conclude that it is a good idea for Congress to intervene because state registration requirements for offering securities are not adding significantly to investor protection, but are retarding capital formation and accompanying economic growth.

THE WILLIAMS ACT

I support the section of H.R. 2131 that repeals several sections of the Williams Act. The Williams Act requires anyone acquiring more than 5 percent of the stock of a publicly traded company to file a report with the SEC disclosing his holdings and intentions. Bidders in tender offers must file reports concerning financing and plans. Tender offers must remain open for about a month. Bidders cannot buy stock

in the market during the offer. Shares in oversubscribed offers must be purchased pro rata. The Williams Act imposes uniformity on tender offers and distributes the gains produced by tender offers from active to passive shareholders. As a result, these tender offer regulations reduce the gains to bidders and thereby reduce the number of tender offers.

The Williams Act is presented as being neutral between bidders and targets. However, its actually burdens and retards bidders without affecting targets. The actions that are prevented by the Williams Act and regulations implementing it are mainly situations in which active shareholders such as the bidder or investors who tender early earn greater benefits from a tender offer than passive shareholders. In my opinion, the securities laws should focus on protecting investors from fraud rather than merely redistributing wealth. It is difficult to understand how prohibiting some shareholders from making an offer for the stock of other shareholders on terms of the offeror's choosing protects investors.

The market for corporate control is an important source of investor protection. The economic evidence is voluminous that tender offers benefit shareholders and economic efficiency. So it is as important that active shareholders have incentives to go directly to other shareholders with an offer to buy their shares as it is that they have incentives to go directly to other shareholders with a proposal in a proxy contest. Under state law, corporations have an array of defensive tactics from which to choose if they oppose a tender offer. It makes no sense that the federal law dealing with tender offers, which purports to be neutral, adds to targets' defenses and prevents some offers from occurring at all.

PRIVATIZING EDGAR

I support the provision of H.R. 2131 that directs the SEC to privatize EDGAR. A private sector system provides a market test for the value of instantaneous disclosure. If analysts and other investors value the information enough to cover its costs, the EDGAR system will provide it. If it is economic to do so, the EDGAR system will incorporate advances in information technology.

By 1982, SEC Chairman John Shad saw that public corporations' filings would have to be computerized or eventually the Commission would be buried in a sea of paper. He proposed a reasonable plan in which private firms would run the EDGAR system and sell the information to those who wanted it instantaneously and others who wanted access to historical information electronically. In other words, the original plan was that EDGAR would be an information system in the private sector. Moreover, the plan was that it would be paid for by users, not financed by tax revenues.

Certain Members of Congress opposed Chairman Shad's plan for EDGAR until it was converted into a government program with Congressional budget control and cost-plus contracts for private sector contractors. The EDGAR program became similar to other government procurement programs: lengthy bidding and rebidding processes, protests by losers, cost over-runs, and lagging technology. When information technology is advancing daily, does it make any sense to have a pure information system such as EDGAR run by the SEC? In my opinion the answer is no.

SUITABILITY FOR INSTITUTIONAL INVESTORS

I support the provision of H.R. 2131 that clarifies the suitability responsibility of broker-dealers to institutional investors. Investment advisors have different responsibilities toward their customers than do broker/dealers. If institutions that pursue risky investment programs can, after investment losses, create advisor responsibilities for broker-dealers and recover losses from them by claiming the securities were unsuitable, then costs of trading will increase because broker-dealers will include an "insurance" premium in their commissions and mark-ups. It would be more efficient to have the question of responsibility for investment decisions decided prior to an investment recommendation. Institutions that want insurance from broker-dealers can contract for it. Institutions that want lower trading costs can forego the insurance of placing additional responsibilities on a broker-dealer. This is the approach taken in H.R. 2131.

As the securities markets have become increasingly institutionalized, the SEC has consistently found that institutions are sophisticated investors capable of fending for themselves. Consequently, the Commission has provided exemptions and other procedures that enable institutional investors to pursue risky investment programs without some of the costs and other restrictions accompanying protections designed for small, individual investors. It would, therefore, be consistent with this view of institutional investors to create a clear presumption that broker-dealers are not responsible for institutions' investment decisions.

THE SEC'S MISSION

I support the provision of H.R. 2131 that directs the SEC to consider the effects of its actions on capital formation, competition, and efficiency. It is impossible to regulate the U.S. securities markets without affecting these factors, so any meaningful analysis of costs and benefits related to Commission actions would take them into account. Moreover, competition and market efficiency are important sources of protection for investors, so it is unlikely that actions to decrease competition or efficiency would actually protect investors.

Generally the Commission does take account of capital formation, competition, and market efficiency as it implements the securities laws. Nevertheless, explicit recognition of these goals by Congress could only improve SEC policy because the Commission and its staff diligently follow the directions set by Congress.

SEC EXEMPTIVE AUTHORITY

I support clarification of the Commission's exemptive authority. However, I urge Congress to clarify that authority beyond the Securities Act of 1933 as proposed in H.R. 2131.

In some areas, the Commission may already have adequate but unused exemptive authority. In other areas, the absence of or precarious exemptive authority may prevent the Commission from using it widely. For example, a reasonable proposal that depended on exemptive authority was withdrawn because the Commission staff argued that exemptive authority in that area was weak and could be lost completely when challenged in court by special interests that opposed the proposal. Overall, it would benefit, capital formation, competition and efficiency if the Commission's exemptive authority was stated clearly for all of the laws that it administers.

CONCLUSION

The Capital Markets Bill will improve regulation of the U.S. securities markets. First, it clarifies the federal securities laws so that market participants will know better what laws they must obey. Second, it states explicitly that actions taken to interpret and enforce the securities laws should consider the effects on competition, efficiency, and capital formation. Third, it reduces duplicative regulations that do not add to protection of investors. Finally, it does not reduce investors' protection against fraud.

Mr. FIELDS. The Chair thanks the gentleman. The Chair will now recognize Mr. J. Carter Beese, vice chairman, Alex Brown International and also a former SEC commissioner. Mr. Beese?

STATEMENT OF J. CARTER BEESE, JR.

Mr. BEESE. Thank you, Mr. Chairman, Representative Markey and members of the committee. I am delighted to have the opportunity to appear before this committee on an issue of critical importance to the future of U.S. capital markets and to the economy as a whole.

This is my first opportunity to appear before this committee since leaving the Securities and Exchange Commission 1 year ago. This is also my first appearance testifying here as chairman of the Capital Markets Regulatory Reform Project sponsored by the Center for Strategic and International Studies.

Mr. Chairman, let me note at the outset how disappointed I am that this effort to streamline the securities laws has been mischaracterized either as a declaration of war on the Securities and Exchange Commission or as the "Crooks and Swindlers Relief Bill." As a former commissioner, I am extremely proud of the vital role that the SEC has played in enabling our Nation to develop the fairest, deepest and most liquid markets in the world. In particular, I believe that vigorous enforcement of our Nation's securities laws is essential to maintaining investor confidence. Having sat at

the enforcement table, I take a back seat to nobody in my commitment to go after bad actors in this market.

At the same time, from my vantage point at the Commission, I became increasingly concerned that our regulatory system has come to impose excessive and unnecessary costs on the overwhelming majority of good faith market participants and that it is becoming a significant threat to continued competitiveness of the U.S. markets.

I think we would do well to remember the words of President Roosevelt at the time of the enactment of the 1933 Act. President Roosevelt said, "The purpose of this regulation is to protect the public with the least possible interference with honest business." It is for that reason that I became a senior adviser at CSIS.

With the assistance of an advisory board comprising leading business, finance and legal executives, we are reviewing all aspects of the capital-raising process with a view toward identifying impediments to efficient capital formation. Since we began this effort, similar projects have been initiated, including the SEC's Advisory Committee on Capital Formation and the Treasury Department's Advisory Committee on Financial Services.

And it is for this reason that I would like to applaud you and the members of the committee for launching this legislative initiative. A fundamental, top-to-bottom review of our Nation's securities laws is timely. Indeed, the Ten Commandments were written for global markets and are divinely flexible.

In contrast, however, it is far too easy today to synthetically circumvent our regulatory system by new technologies, by new instruments, such as OTC derivatives, and by simply trading offshore. We do lose market share every day in this country, I believe, the regulated markets do, to the offshore markets and the unregulated markets.

Quite simply, securities markets have changed in ways that could not have been prophetically foreseen by the drafters of the original securities laws. Today's markets are global in scope. Vast sums of capital flow across borders at the stroke of a computer key. Investors and issuers alike can buy and sell risk in all markets around the globe. Today's computer technology has enabled financial engineers to slice and dice cash-flows and to create a vast array of complex financial products specifically tailored to meet virtually any risk profile.

Today's markets are dominated by large institutions. Where individuals used to account for the vast majority of marketplace activity, the opposite is now true, with mutual funds, pension funds and insurance companies accounting for more than two-thirds of all trading volume.

These changes have major implications not only for market participants but also for legislatures and regulators charged with overseeing them. In particular, U.S. markets are now part of a global competition for capital in which the cost and quality of regulation are a competitive factor.

While the Commission has done a successful job of accommodating some of these changes through regulation, in many areas more fundamental changes, I believe, are necessary and some of them need to be legislative.

In addition, the current regulatory structure has fostered the development of certain de facto monopolies. These institutions were designed with the best of intentions in an era of relatively primitive technologies of insulated domestic markets. In that era, these regulated entities helped reduce the cost of raising capital by making the process more efficient.

Mr. Chairman, I'll submit the rest of my remarks for the record.

[The prepared statement of J. Carter Beese, Jr. follows:]

PREPARED STATEMENT OF J. CARTER BEESE, JR., VICE CHAIRMAN, ALEX. BROWN INTERNATIONAL

Mr. Chairman, Representative Markey, and Members of the Committee. I am delighted to have the opportunity to appear before this Committee on an issue of critical importance to the future of the U.S. capital markets and the economy as a whole. This is my first opportunity to appear before this Committee since leaving the Securities and Exchange Commission in November to rejoin Alex. Brown & Sons as Vice Chairman of Alex. Brown International. This is also my first appearance testifying here as Chairman of the Capital Markets Regulatory Reform Project Center for Strategic and International Studies.[1]

Mr. Chairman, let me note at the outset that we have a high-quality regulatory system that has been a partner in developing markets that are the fairest, deepest and most liquid in the world. However, from my vantage point at the Commission, I became increasingly concerned that this same regulatory system is imposing excessive and unnecessary costs on market participants and is becoming a significant threat to the continued competitiveness of the U.S. capital markets. It is for this reason that I became a Senior Adviser at CSIS and agreed to chair the Capital Markets Regulatory Reform Project. With the assistance of an advisory board comprising leading business, finance, and legal executives, we are reviewing all aspects of the capital raising process with a view toward identifying impediments to efficient capital formation. Since we began this effort, similar projects have been initiated, including the SEC's Advisory Committee on Capital Formation and the Treasury Department's Advisory Commission on Financial Services.

It is also for this reason that I would like to applaud you and the members of the Committee for launching this legislative initiative and for conducting today's hearing. A fundamental, top-to-bottom review of our nation's securities laws is timely. During the past twenty years, virtually every successful private sector company in this country, from high tech to health care has undergone dramatic changes in order to meet the challenges of today's marketplace. Terms like "reinventing" and "reengineering" permeate our corporate offices, describing a complete overhaul of manufacturing processes, distribution systems and sales practices.[2] Having worked with many of our nation's leading growth companies in my role at Alex. Brown, and having then spent nearly three years serving as an SEC Commissioner, I can say from experience that the SEC—and the regulatory system it administers—should undergo its own exercise in reengineering. The scrutiny that you are applying is healthy and well-deserved.

This effort has important ramifications both within and outside of the legislative process. By setting the legislative gears in motion, you have provided a forum for debating critically important reforms. As my testimony today will indicate, I support many of these proposals wholeheartedly. Others will require certain modifications, and I am sure you are receiving no shortage of suggestions in that regard. The introduction of H.R. 2131 and the conduct of hearings such as this is the beginning, however, and not the end. In all the back and forth, it is critical not to lose sight of the underlying necessity to move our statutory scheme from the industrial age to the information age.

As importantly, your efforts also have an impact beyond the parameters of the statutes that you seek to revise. The tone that you set as an oversight committee communicates public policy directions to all of the agencies in your jurisdiction.

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[1] CSIS is a nonpartisan public policy research institute based in Washington, D.C. that provides policymakers with a strategic perspective on issues relating to international finance and economics, politics and global security matters.

[2] See, *e.g.*, Michael Hammer and James Champy, *Reengineering the Corporation: A Manifesto for Business Revolution* (New York, N.Y., HarperCollins Publishers, 1993). The authors note: Advanced technologies, the disappearance of boundaries between national markets, and the altered expectations of customers have combined to make the goals, methods, and basic organizing principles of the American corporation sadly obsolete. *Id.* at 11.

Already, the SEC has announced the creation of a task force led by Philip Howard, author of *The Death of Common Sense,* to conduct a review of the agency's regulations and seek detailed views from corporate leaders on what needs to be changed. The Commission, and Chairman Levitt in particular, deserve credit and support for undertaking this endeavor.

Clearly, the proof will be in the product. But the bottom line, Mr. Chairman, is that the playing field has fundamentally changed. Creeping incrementalism appears finally to be giving way to comprehensive reform. Your efforts are already bearing fruit.

I believe that effective regulation plays a vital role in maintaining the health and integrity of the financial markets. Investors must be confident that they will be treated fairly before placing their hard-earned savings at risk. Underpinning that confidence is a regulatory and legal structure that provides full, fair and timely disclosure, as well as vigilant oversight of market activities and vigorous enforcement of violations of law. In that regard, our system of securities regulation deserves credit for helping support the fairest, deepest and most liquid market in the world.

At the same time, however, a system that fails to keep pace with market developments and imposes unnecessary cost will dissuade issuers by needlessly raising the cost of capital. In today's marketplace where capital flows uninterrupted across borders and oceans, excessive regulatory cost is simply a luxury that we can no longer afford.

NEED FOR REFORM

The financial regulatory system that we confront today is fundamentally the legacy of a bygone era. We have a system that was perfectly crafted to meet the challenges of the 1930's, which, of course, have now given way to a completely new set of challenges. Even then, however, concerns were raised about the possible impact of regulation on the markets. President Roosevelt, in his letter to Congress accompanying the introduction of what would become the Securities Act of 1933 wrote, "The purpose of this legislation . . . is to protect the public with the least possible interference with honest business."[3]

On top of this structure, we have then layered regulation upon regulation with alarmingly little economic analysis. In my experience at the Commission, very little consideration is given to the costs of particular regulations relative to the public benefits. Statutes such as the Regulatory Flexibility Act and the Paperwork Reduction Act are given no more than superficial attention in Commission rule proposals, usually just a sentence or two of boilerplate discussion. More importantly, there is virtually no consideration of the aggregate regulatory burden placed on the marketplace. Instead, as regulators, we tended to address a crisis or market development as it arose. Each change seemed eminently reasonable in isolation.

The result, however, is a regulatory house built not by blueprint, but by change order—just as cumbersome and equally costly. Redundancy and inefficiency abound. Examples include overlapping state and federal registration requirements and a virtual alphabet soup of financial regulatory agencies. Even the staunchest opponent of this legislation cannot defend such a system.

In addition, the current regulatory structure has fostered the development of certain de facto monopolies. These institutions were designed with the best of intentions in an era of relatively primitive technologies and of insulated domestic markets. In that era, these regulated entities helped reduce the costs of raising capital by making the market processes more efficient. However, these institutions and the regulatory framework that created them need to be re-evaluated in the context of the realities of the now globalized capital markets and the significantly more advanced technologies, as noted below.

CHANGING MARKET ENVIRONMENT

As we look ahead, it is important to recognize the tremendous changes that have taken place in the markets. These changes have major ramifications not only for market participants, but also for the legislators and regulators charged with overseeing them. In contrast to the domestic, insular markets that confronted regulators in past decades, today's regulators face a marketplace in which they no longer possess monopoly power. Global capital markets are now intensively competitive and often the decisive factor for issuers and investors in selecting a market is the relative cost of complying with the regulatory requirements of that market. In this

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[3] Letter from President Roosevelt to the Congress, March 29, 1933. Cong. Rec. 937 (March 29, 1933).

environment, efficiency is a competitive factor, and Darwin's rules apply. I should emphasize that I am not advocating a regulatory race to the bottom, or that such a race is likely to occur. To the contrary, cost-effective regulation, combined with a wide-ranging and vigorous enforcement program, will be a competitive advantage and enhance the capital formation process.

Internationalization

Twenty years ago, capital respected national boundaries. Americans traded in New York, the British traded in London, and so forth. Today, that is no longer the case. Rather, the decade of the 1990s is likely to be remembered as the decade of cross-border capital flows. Both investors and issuers find the world increasingly at their feet, and neither have been shy about taking advantage.

In 1980, foreign purchases and sales of U.S. securities together amounted to slightly over $75 billion. Fourteen years later, in 1994, that figure topped $700 billion.[4] Total foreign trading in U.S. equity securities has grown at a compounded annual rate of over 17 percent. Viewed over the last decade, however, the comparison is more dramatic. Since 1984, the volume of foreign trading in U.S. securities has risen at a compound annual rate of 18.95 percent, while the York Stock Exchange volume has grown 12.34 percent annually.[5] Foreign participation has outstripped domestic market growth by over 50 percent.

For their part, U.S. investors have shown a similar desire to participate in the globalization trend. Fifteen years ago, the aggregate U.S. purchases and sales of securities in foreign markets stood at $17.9 billion. By 1994, it had grown to over $850 billion. The compound annual growth rate for the period exceeded 30 percent.[6]

Helping drive the globalization trend are emerging markets around the globe. Political and social changes in the last decade have combined to open markets from Eastern Europe to the Pacific Rim. The market capitalization of the 21 countries that make up the International Finance Corporation's composite emerging market index grew from $352 billion in 1988 to over $1.1 trillion in 1993.[7] By way of comparison, the total capitalization of all the stock markets in the industrialized countries has grown from $9.4 trillion to about $12.5 trillion in the same five-year period.[8]

As these new markets have grown, they have attracted considerable foreign investment. According to research by Barings Securities of London, net capital flows to developing country equity markets rose to $52 billion in 1993 from only $14 billion in 1992 and $1.3 billion five years ago.[9]

Adding momentum to the international trend are large issuers that face capital constraints in their home markets. In particular, the wave of privatizations currently taking place around the globe often exceeds the capital capacity of their home markets. Such enormous transactions require global offerings whereby individual tranches can be offered in multiple markets. At the same time, however, private companies are also looking abroad for lowcost capital. Daimler Benz which attracted headlines in 1993 with its listing on the New York Stock Exchange, is now listed on exchanges in eight countries—Germany, Switzerland, the United Kingdom, the United States, Japan, Austria, France, and, most recently, Singapore. The company's chief financial officer has stated that the company intends to have 5 percent of all of its shareholders in Asia by the year 2005 and would like to be the first foreign company listed on the Shanghai Exchange.[10]

Advanced Technologies

Modern technology has enabled much of the revolution in the world's capital markets. As computers and advanced telecommunications equipment have become available, the investment community has proven to be a huge customer. The head of CS First Boston, recently estimated that the firm has spent over $800 million on tech-

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[4] Source: U.S. Treasury Bulletin.

[5] New York Stock Exchange Fact Book (1994).

[6] See *ibid.*, note 3.

[7] Daniel F. Adams, "Financial Markets and World Economic Growth: Perspectives Towards the 21st Century" (Remarks at the 1994 Conference of the International Organization of Securities Commissioners, Tokyo, October 19, 1994).

[8] David D. Hale, "Stock Markets in the New World Order," *Columbia Journal of World Business* 29 (June 1994), p. 14.

[9] See *ibid.*, note 7.

[10] Richard House "A Question of Control," *Institutional Investor*, international ed., 20 (April 1, 1995), p. 36.

nology in the last three years alone.[11] Likewise, the New York Stock Exchange has installed over $1 billion worth of new technology on its trading floor since 1985.[12]

The effect of modern technology is to make global investment possible. From an execution standpoint, portfolio and risk managers now allocate assets among markets at the stroke of a computer key. At the same time, news services and data transmission provide access to essential information from around the world on a real-time basis. It is no longer necessary to have a physical presence in a given area in order to monitor events that affect one's investment.

While telecommunications provides access and information, computer technology enables market participants to harness the information flow and take advantage of global opportunities. Managing complex portfolios and geographically dispersed investment exposure depends upon cutting-edge computer modeling. Dennis Weatherstone, former head of J. P. Morgan, demanded to be updated at each day's end on the institution's net global exposure in the numerous countries in which the company conducts business. Only through recent technological advancements and intense computer modeling could such reports ever be prepared.

Computer technology has also accelerated the pace of financial engineering and new product development, particularly in the area of derivatives. It is now possible to slice and dice cash flows along virtually any dimension. In the process, market participants easily circumvent national boundaries, taking or hedging exposure in a particular market or currency at times without even crossing the borders of a particular market.

Institutionalization

The third development transforming the capital markets has been the growth of institutional investment through pension funds, mutual funds, and insurance companies. Between 1975 and 1993, the share of the U.S. equity market owned through mutual funds has more than doubled, from about 4 percent in 1975 to almost 11 percent in 1993. During the same period, the value of U.S. equity securities owned by private and public pension plans increased more than tenfold from $132 billion to $1.6 trillion. The present holdings of one of the nation's largest pension plans are almost equal to the amount that was held by all public pension plans collectively in 1975.[13]

Most importantly, institutions now dominate market activity. Institutional investors, which hold just over half of all U.S. equities, account for more than two-thirds of all trading on the New York Stock Exchange.[14] They are even more dominant in off-exchange and overseas markets. This is in direct contrast to the situation that existed in the 1930s when the federal securities laws were first adopted. At that time, retail investors accounted for the overwhelming majority of trading activity.

While the character of the markets has changed dramatically, the legal and regulatory system has not evolved sufficiently to reflect these developments. Generally speaking, institutional investors have the financial strength and sophistication to fend for themselves and do not need all the protections provided by the federal securities laws for the benefit of retail investors. The U.S. regulatory system imposes unnecessary costs on these market participants, these same participants are those most able to take their business elsewhere. An inflexible regulatory system not only runs the risk of pushing business off-shore, but markets may develop outside the reach of responsible regulation. If that happens, investor protection and systemic risk concerns are heightened, not lessened.

POLICY IMPLICATIONS

Together, globalization, technological change, and institutionalization have transformed the landscape of finance. The changes have important ramifications for markets and regulators alike. In particular, the preeminence of the U.S. markets is hardly assured. Although the U.S. markets have increased significantly in absolute size, their percentage of the world's total equity market capitalization has dropped from approximately 90 percent to only about 30 percent. At the beginning of 1980,

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[11] Allen D. Wheat, "Glass-Steagall Versus the Market: The Market Wins," *Investment Dealers Digest,* May 22, 1994, p.21.

[12] Phillip Maher, "The New Wall Street: On to the Millennium," *Investment Dealers Digest,* May 22, 1995, p.5.

[13] Testimony of SEC Chairman Arthur Levitt, before the Committee on Banking, Housing and Urban Affairs, United States Senate, January 5, 1995.

[14] Securities Industry Fact Book. 1994. Securities Industry Association, p.32.

the U.S. equity market was four times larger than its nearest competitor. By 1994, that advantage had been more than halved.[15]

The decline has not thus far been detrimental. The competitive position of the U.S. markets following World War II was not sustainable, and certainly, some of the recent shift can be traced to the decline of the dollar. Moreover, positive market development overseas has helped to fuel global economic growth, particularly in the emerging market countries. The benefits of such development accrue to all nations around the world.

Now is no time to deny the changes that have taken place, however. In doing so, we risk careening toward the next century with our eyes squarely on the rear view mirror. By recognizing the changing nature of market participants and retooling our regulatory system accordingly, we will lower the cost of capital and improve our competitive position. Alternatively, forcing market participants to accept overly costly regulations will simply drive other markets overseas.

The flow of capital out of the United States and into the Eurobond market should be a warning to U.S. policymakers about the impact of excessive regulatory costs. In the 1960's, the United States instituted a 30 percent withholding tax on interest paid on bonds sold in the United States to foreign investors. The legislation was tremendously successful in raising revenue, in the short-run for the U.S., and over the long-term for Britain. It provided the catalyst for the Eurobond market. Despite the subsequent repeal of the legislation, the market has largely remained overseas.[16]

In recent years, the SEC has taken some significant steps to respond to these developments. These would include measures such as Rule 144A, Rule 415 and Reg S. Rule 144A which enables issuers to sell securities in the U.S. markets to certain investors without registering the offering with the SEC, is particularly important because it recognizes the concept of two-tiered markets. The marketplace has developed a disclosure regime that is generally accepted for the purposes of rule 144A transactions, and this regime is much less rigid than the disclosure requirements prescribed by the SEC for full public offerings. More recently, actions have been taken to streamline the registration process for foreign issuers and address some of the differences in international accounting standards.[17]

H.R. 2131

Mr. Chairman, the sweeping initiative that you have undertaken offers a welcome chance to retool our regulatory market for the 21st century. Considered in the context of the market environment that existed in the 1930's, the changes you propose might seem radical and ill-considered. But when viewed in context of the marketplace that exists today, many of the changes are long overdue.

Promotion of Efficiency, Competition, and Capital Formation

I begin with this provision because it best encapsulates the approach to regulation that is necessary for the future. Historically, the SEC has focused on investor protection which, as I have indicated, provides the underpinnings of successful market development. It is important to recognize, however, that investor protection is not an end in itself, but only a means to accomplishing the goal of efficiently moving capital from suppliers to users. Only where investor protection is provided in an efficient and cost-effective manner will markets thrive. Where excessive regulatory burdens impose unnecessary barriers to the capital formation process, however, markets will wither. By injecting efficiency and competition into the regulatory equation, H.R. 2131 seeks ensure healthy, vibrant markets in the future that will benefit issuers and investors alike.

Uniform National System of Securities Offerings

A more controversial element of H.R. 2131 concerns the preemption of the 51 sets of state securities regulations that issuers currently confront when they conduct an offering that is also registered with the SEC. This would effectively establish a uniform national standard for capital raising.

Clearly, there is a role for the states, particularly in the area of enforcement. Regulators and market participants alike would benefit from a more efficient division of duties. In that regard, the bill would not eliminate the state securities commissions or eliminate their ability to assess filing fees. Instead, the staff of the state

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[15] 5SEC, Division of Market Regulation, Market 2000: An Examination of Current Equity Market Developments (Washington, D.C., January 1994), exhibit 6.

[16] Merton H. Miller, Financial Innovations and Market Volatility (Cambridge, MA, Blackwell, 1991).

[17] See testimony of SEC Chairman Arthur Levitt before the Committee on Banking, Housing and Urban Affairs, United States Senate, September 2, 1994.

commissions would remain in the field, enforcing the uniform, federal securities laws.

To impose 51 sets of state regulation flies in the face of the realities of today's national, indeed global markets. Take the merit review system that exists in approximately half of the states. Under merit review, states literally decide if a business deal is "fair, just and equitable." While the state statutes are, in many cases, relatively uniform, having multiple state securities commissions opine on issues such as cheap stock and underwriter's compensation injects a degree of uncertainty into the system that is no longer acceptable.

Instead, uniform national, and ultimately international, standards are the direction of the future. Europe is already moving quickly in this direction through the EC Listing Directives. For instance, an issuer that registers its offering in one EC country can sell across national borders throughout the Community. Issuers registering offerings in London can use the same offering documents for sales of securities in Amsterdam, Madrid and Rome.

Prospectus Requirements

Another area that is ripe for reform is the prospectus. Already, this legislation has helped spur the SEC to issue an Interpretive Release and a companion rule proposal to facilitate the electronic dissemination of prospectuses and other related materials.[18] The Commission states that as a general matter, it would view "information distributed through electronic means as satisfying the delivery or transmission requirements of the federal securities laws." As on-line services and the Internet proliferate, the benefits of such an approach are clear.

The legislation further proposes to eliminate the requirement that prospectuses even be delivered to investors who do not request them. Given that many investors never bother to read the material, any lessening of investor protection created by such a provision is likely to be minimal relative to the cost savings. Even better would be to simplify the documents so that investors might find them more useful. There is a point when more becomes less, particularly when more becomes mountains of boilerplate "legalese." Our prospectuses are increasingly moving from consumer information materials to litigation tools, written by lawyers for lawyers, with investors losing out in the process.

Suitability

Finally, I would like to take a few moments to touch upon suitability. In light of the much-publicized losses realized by Orange County and the state of West Virginia, suitability has become a hot issue in the press as well as the financial community. Large institutional investors have sought to use the suitability rules of the self-regulatory organizations to recover trading losses from their dealer/counterparty. H.R. 2131 would preclude the application of self-regulatory organization suitability rules for the investment decisions of institutional investors managing more than $10 million, unless there is an agreement to the contrary. It also establishes a presumption in private suits that a broker-dealer is not responsible for the investment decisions of institutional clients.

The fact is that the large institutions which increasingly dominate our markets ought to be able to take care of themselves. Indeed, it is incumbent upon those managing funds on behalf of institutions to understand the risks associated with instruments in the institutions' portfolio.

Whether $10 million is a sufficient bar is an open question. Personally, I would like to see a higher threshold. The goal, however, ought not be to provide insurance for every investment that goes down. After all, markets exist to transfer risk. If they inhibit that transfer unnecessarily, we'll wind up having no markets at all.

At the same time, fraud is fraud, no matter whom it is committed against. Importantly, H.R. 2131 provides no bar to recovery in instances of fraud. If an investor can prove fraud in a given transaction, recovery is clearly in order, regardless of the size of the portfolio involved.

ADDITIONAL REFORMS

Mr. Chairman, as important as these changes are, I believe they are part of a broader reform effort needed to ensure that our legal and regulatory structure reflects the realities of today's global, dynamic marketplace. Looking to the future, more structural regulatory reform is essential if the U.S. markets are to remain competitive. The entire regulatory system would benefit from reexamination and a shift in focus toward weighing the costs and benefits of regulation.

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[18] Release Numbers 33-7233 and 34-7233. Federal Register, October 13, 1995.

In this regard, as I stated on previous occasions, the most important action Congress can take to lower the cost of capital in the U.S. is to address the imbalance in our securities litigation system. I know that the House and Senate are attempting to resolve the differences between the measures that passed both bodies by overwhelming margins, and I want to underscore my support for your efforts.

Other actions include removing the artificial barriers to competition imposed by the Glass-Steagall and Bank Holding Company Acts, making U.S. markets more attractive to foreign investors by eliminating the current disincentive in the tax code for foreign investors to invest in U.S. mutual funds, and adopting needed changes to the Investment Company Act, such as those you and Rep. Markey have proposed in H.R. 1495.

CONCLUSION

Mr. Chairman, the SEC has been fortunate over its 60-year history to regulate captive markets that were relatively insensitive to regulatory expense. In this environment, the U.S. developed the highest quality regulatory system in the world. Unfortunately, it is also one that is high cost.

Much of the regulation administered or developed by the SEC and the nation's other fragmented financial regulatory agencies is a product of a different time and a different environment. Continuing to add layer upon layer is not the recipe for continued success. Rather, the introduction of H.R. 2131 should be the beginning of an effort to retool our regulatory system for the 21st century.

Mr. FIELDS. Your testimony will appear in the record in its totality.

Mr. Saul Cohen of Rosenman & Colin. Mr. Cohen?

STATEMENT OF SAUL S. COHEN

Mr. COHEN. Good morning. A Sunday New York Times financial section of several weeks ago provides a reasonable sense of where we are when we think of the context for securities regulation. Once a reflection of the doings of Wall Street and its brokerage firms, today the section is built around personal investing. The section's lead story, "Building a better 401(k)," was a discussion of investment alternatives offered by various mutual fund groups.

There were three other articles devoted to mutual funds and 3½ pages of fund listings, more than the combined listings of the New York and American Stock Exchanges.

The section contained one article on investors who make individual trading decisions. These investors were unflatteringly characterized as restless, always seeking a bigger high, relishing action, nuts for doing their own research. They were advised "to see if their avocation is taking on hues of a gambling addiction." Along with the section's mutual fund coverage, one such investor tells us exactly where we are now. "My dream," he says, "would be to stay home with a couple of TV sets with all these financial stations on and a computer to do my own trading." He might even be a smoker.

Securities regulation was built at great cost to protect that poorly regarded dreamer who makes his own investment decisions, but today the great majority of individual investors have turned over their investing to sophisticated proxies: investment advisers, mutual funds and annuities. Securities regulation must change to recognize that protecting the individual investor means paying close attention to these proxies, making markets efficient for the block trades composed of the savings of many individuals and avoiding systemic risks caused by the failure of a market participant.

Over the past year, the investing public has been dismayed by the regularity of occurrence at world famous large, even venerable

institutions of what until recently would have been once-in-a-generation disasters. Seemingly, each quarter reveals a new Kidder Peabody, Barings or Daiwa Bank scandal, enormous losses with common themes of so-called rogue traders and their stupid, inattentive and perhaps venal supervisors. The investing public might well ask, "But where are the regulators?"

I believe that, focussed on the individual investors of the past, securities regulators are failing to react to what is occurring about us. That is: the blurring between the traditional agency business of a broker and the almost hedge fund world of dealers; the massive growth of dealer capital to finance their inventories; the development of exotic instruments, such as derivatives, which are intended to manage the risks of such inventories and other business needs but create poorly understood risks of their own; the internationalization of investing at the same time regulations among world markets vary as to net capital requirements, trade settlement, et cetera.

I have just this month had two broker-dealer clients come to me about advice as to Federal and State regulations regarding sales of securities to U.S. investors in Russia. These are Russian and Indian securities.

And, most importantly for an investor protection process built on the channeling of information from corporations to investors, the existence of multiple sources of information, the Internet being just one.

The roots of this regulatory failure are addressed by H.R. 2131. The bill sounds the call for a restructuring of American securities regulation and advances eminently sensible proposals to make regulation more responsive. I can't touch on all of these proposals but wish to state my support for four critical items.

One, the proposed suitability process which, while reflecting certain responsibilities inherent in broker-dealer licensing and professional standards, narrows the policy's breadth to respond to more likely need.

Two, the updating of credit regulation which will both allow the more flexible use of margin and securities transactions and lower brokerage firm and customer costs by providing alternative borrowing sources.

Three, the restatement of the SEC's mission to balance its traditional emphasis on protecting investors who make individual trading decisions with the channeling of capital to its most productive use in the public interest and the need for efficient markets.

And four, perhaps more importantly, the reconfiguration of securities regulation to provide a national system for the effective deployment of regulatory resources on a coordinated basis.

Thank you.

[The prepared statement of Saul S. Cohen follows:]

Prepared Statement of Saul S. Cohen, Rosenman & Colin LLP

I. INTRODUCTION

Over the past year the investing public has been surprised and dismayed by the regularity of occurrence at world-famous, large, sophisticated, even venerable financial institutions of what until recently would have been once in a generation disasters. Seemingly, each quarter reveals a new Kidder, Peabody, Barings Bank or

Daiwa Bank scandal, losses to a billion dollars or more with common themes: illusory profits running for years; schemes with supposedly simple and riskless cores—unwinding strips of government securities, arbitraging markets, trading governments in size; so-called "rogue traders" but certainly, stupid, inattentive and perhaps venal supervisors.

Most importantly, is the failure of regulators here and abroad, focused on the concerns of the past, to forestall these disasters and provide confidence to investors. The roots of this failure are addressed by the Capital Markets Deregulation and Liberalization Act of 1995 (H.R. 2131), which sounds the call for a restructuring of American securities regulation and advances eminently sensible proposals to make regulation more responsive to present needs.

At present, securities regulation resembles an archaeological dig: state regulation, the oldest stratum, the level above made up of various self-regulatory organizations and both topped by the Securities and Exchange Commission. (The Commission itself, responsible for only a small part of the investment spectrum and participants.) Each layer has its own powers and priorities and though all profess a common faith—the primacy of the individual investor—their coordination is sporadic, haphazard and often duplicative. The result is not only needlessly expensive and inefficient, but the blurring of responsibility and emphasis on individual investors create the context for the debacles noted above.

Protecting the individual investor should be a primary aim of regulation. This was true when the federal securities laws were written in the nineteen-thirties and is true today. After all, the American financial markets do not resemble Germany's, to take one example. Americans are proudly individualistic, seek to make their own decisions and though the volume placed by individuals comprises only 10-15% of the equity markets that volume and the investors who trade these securities are an enormous multiple of size and participation in Exchange and over-the-counter business compared to sixty years ago.

But what the regulators have noticed, yet not adequately responded to, is that individual investors in the nineties are much better educated and informed (25% of the population is college educated and the Wall Street Journal is the nation's largest circulation newspaper) than their Depression era counterparts and in great numbers have given their savings to institutional agents to invest. Individuals' funds are invested through mutual funds, pension plans, investment advisors and annuities; these investments are made in foreign as well as domestic markets. Thus capital flows freely across borders while trading continues twenty-four hours a day. Kansas was one of the first states to enact blue-sky regulation but we have not been in Kansas for a long time.

What is occurring about us is: a blurring between the traditional agency business of a broker and the semi-hedge fund world of dealers; the massive growth of capital among dealers to finance these dealer markets (Morgan Stanley & Co. Incorporated's capital twenty-five years ago was $7.5 million; today it is above $13 billion); the development of exotic instruments such as derivatives which serve the important purpose of risk management but create poorly understood risks of their own; the internationalization of markets at the same time regulations among markets vary as to net capital requirements, trade settlement, etc.; and the existence of multiple sources for information which are swamping the traditional regulatory channeling of information, a channeling designed to ensure both the quality of information presented and reasonable access to it. This categorization and direction has been the SEC's greatest contribution to markets and investors.

Thus, one of these sources, the Internet allows: a) retail investors of certain brokerage firms to enter on-line orders for securities in a variety of modes—limit and stop-loss orders, good to cancel orders, etc.—without dealing with a registered representative; b) issuers without an underwriter or sales agent to offer their securities to the public; but for the first time cheaply and effectively; c) access to research from a number of purveyors independent of registered brokers and advisers; d) brokerage firms to provide to customers and surfers a wide variety of financial information on "home-pages"; e) realtime interviews with company officials about corporate developments and prospects.

These developments place in a small corner the traditional regulatory concerns of confirmation disclosure and delivery, compilation of complaint statistics, and multiple registration of personnel. These developments also raise the questions this legislation addresses:

Does securities regulation as it exists today unnecessarily impact the capital formation process?

Is regulation as it is practiced in the age of Barings and Orange County doing the investing public any good?

Do regulators have a sense of mission and, if so, how do they articulate it?

II. RECOMMENDATIONS REGARDING SELECTED PROVISIONS OF H.R. 2131 SUITABILITY

We support section 2 of the proposed Act which limits suitability policy to institutions which have less that $10 million invested in securities, except where otherwise agreed by the parties. We believe this proposal is a useful starting point for a re-examination of the suitability doctrine. The doctrine emerged logically from responsibilities inherent in broker-dealer licensing and professional standards; however, in the past few years suitability has been used to avoid losses by institutional parties with the sophistication and/or assets to retain advisers internally or externally. Beyond this, suitability concepts have furnished the platform for a number of "dramshop" awards by judicial forums to customers who while not following brokerage firm recommendations traded recklessly to their own injury.

For the reasons set out in the Introduction the concepts relative to suitability should be re-examined in light of the higher educational and sophistication level of customer's and their access to investment information. The Act should go further and provide that a) brokers are not responsible for suitability where the account is managed by an investment adviser; b) brokers are not responsible for account losses under suitability theory unless the loss follows a recommendation by the broker; c) the institution certify the amount of assets it has invested in securities at the outset of its relationship with the broker, failing which certification it will be presumed the institution has $10 million invested in securities, and further that the institution notify the broker if, at any time its securities invested assets fall below $10 million; d) "securities" include both marketable and unmarketable securities as well as money market instruments; and e) even if the asset size or written agreement conditions are not met there is no presumption that the broker is liable for the investment decisions of a client.

National Unified System of Securities Regulation

We support Section 3 of the proposed Act which for the first time creates a national unified system of securities regulation. We urge that this be considered a first step in the reconfiguring of American securities regulation and have proposed in Section III below what we believe is an efficient deployment of regulatory resources on a coordinated basis.

Section 3, of course, does not preempt a role for the states in securities regulation. Rather, it charts a course whereby they can, through enforcement activities, aid in insuring the legitimacy of securities offerings. At the same time, the Section removes the unnecessary cost merit regulation brings to the capital formation process; a cost that is not balanced by any state regulator's ability to weigh, better than the market itself, the investment value of offerings.

Again, Section 3 re-focuses state attention on enforcement issues. For example, most states today have enacted the Uniform Securities Act, which contains books and records provisions which mirror the Securities Exchange Act. Thus there is reasonable uniformity. Nevertheless, certain states have pressed the North American Securities Administrators Association for a state model of books and records requirements which would vary from federal regulation, and NASAA has recently advanced a fourth draft of such a proposal. Without addressing the specific items of the model, we believe that it particularizes rather than universalizes an area of regulation mandated at the federal level and consider it obvious that even if such model were promulgated, it would not be accepted or would have variations among the several states. It is exactly this particularist approach which Section 3 would eliminate. Rather, the Securities and Exchange commission is directed to cooperate with NASAA in promoting uniformity in the federal-state "regulation of the securities business". In this regard, we believe that the Act's authorization of the SEC to exempt state record keeping and registration requirements undermines the uniformity which should be the standard of regulation.

Margin Rules

We support Section 4 of the proposed Act which would update credit regulation usefully.

Credit regulation in securities transactions, underwritings and loans to brokers is a product of the crash of 1929 and the Great Depression. At the time of the enactment of Sections 7 and 11(d) of the Securities Exchange Act it was believed that undue credit provided to the securities markets had led to speculative excess and the crash, while at the same time starving farmers and other producers of necessary capital. To this was added a layer of protection of brokerage customers so that in Sam Rayburn's famous mixed metaphor "a person cannot get in the market on a shoestring one day and be one of the sheared lambs when he wakes up the next morning." (78 Cong. Rec. 7700 (1934)) Whatever the accuracy then of this economic

analysis and populist belief it is apparent today that securities credit regulation should be overhauled.

As a practical matter the Federal Reserve Board places few margin restrictions on fixed income securities and there is no good reason why these should not be eliminated as the act proposes. We agree that institutions should be excluded from such restrictions but consider that the definition of Institution in Section 4 should be made uniform with that of Section 2, and in this regard prefer the Section 4 definition. We believe that, in fact, credit regulation of retail customers investments in equity securities might safely be eliminated as well. (This would leave only the provision of Section 7 permitting the FRB to reinstitute regulation to deal with financial panic.) There is no reason why brokerage firms, subject to net capital considerations, should not be permitted to compete for business based on the level of credit they are willing to extend to customers. The situation should be likened to the anti-competitive pre-May 1, 1975 period of fixed commission rates.

We believe the proposed Act is unduly conservative in limiting Section 11(d) to non-institutional customers. We see no difference in making investments on margin after thirty days or before, nor do we believe that the investment merits of new offerings or their pricing will be changed if margin is available on the issue's effective date. If there is doubt on this subject, the Commission should be mandated to submit a report and provide a recommendation as to action.

We also support the amendment of Section 8 to allow broader sources of credit to broker-dealer borrowers. Since the enactment of Section 8, securities firms have developed alternatives to bank financing such as repurchase transactions to meet their funding needs. Permitting firms to borrow from entities other than banks will allow for greater competition and ultimately lower the securities related borrowing costs of broker-dealer customers.

The Mission of the SEC

For the reasons set out in the Introduction we support the restatement of the Commission's mission provided by Section 8. The Commission's traditional emphasis on the primacy of protecting the individual trading decisions of investors must be balanced with the channeling of capital to its most productive use in the public interest and the importance to investors of efficient markets.

Reduction in SEC Commissioners

We are opposed to Section 9 which would reduce the number of SEC commissioners from five to three. We believe that at least five commissioners are needed to meet the SEC's expanded mission, as the Act proposes, of efficient markets and capital formation. A larger number of commissioners allows for representation from a broader range of constituencies interested and able to contribute to the Commission's work. It also allows for the possibility of greater due process offered to those subject to the Commissioner's jurisdiction, not least in the Wells submission aspect of the enforcement process.

Designating a Primary Self-Regulatory Authority

Broker-dealers today have a primary examining authority. For New York Stock Exchange members it is the NYSE; for non-Exchange members the authority is normally the NASD. We support Section 12 which would in effect limit the examination of broker-dealers to this primary examining authority.

We wish to note though the following concerns which must be addressed in this regard: the provision will not remedy the inconsistencies which arise from a situation in which a carrying firm is an NYSE member and the introducing firm is not. Further, to some extent the NYSE and NASD have different areas of interest; for example, mark-ups and corporate finance are generally NASD rather than NYSE concerns. The proper resolution, we believe, is set forth in the final Section of our Statement: specifically, that the self-regulatory organizations be limited to policing their markets and that their examinations address only net capital and market related matters.

III. RESTRUCTURING SECURITIES REGULATION

To allow for efficient capital formation, to protect capital markets and the individual investor regulation must address:

1. The risks inherent in financial enterprises;
2. The complexities of specially designed financial instruments;
3. The enormous range and supply of financial assets created through securitization of mortgages, credit card debt, etc.;
4. The transparency and depth of markets;
5. The credit-worthiness of market participants;

6. The flow of information from unlimited sources.

Our existing regulatory construct comprised of the Securities and Exchange Commission on the federal level, the states and self-regulatory organizations, can be configured to deal with these subjects and accomplish these aims. We urge this Subcommittee to consider certain additional reforms that are not specifically addressed in H.R. 2131.

U.S. SECURITIES AND EXCHANGE COMMISSION

Since its inception in 1934, the SEC has been properly viewed as a, if not the, premier United States government regulatory agency. The Commission's staff is an elite group of dedicated professionals. Because of its success, the concept of an SEC has been replicated in countries throughout the world as market based economies have grown in the past twenty years.

It is hard to imagine how our markets would have reached their present strengths without the confidence created in investors by the Commission. Graduates of the Commission's staff add to this confidence and common understanding of securities regulation by playing important roles within and as advisors to the financial services industry. Nevertheless, it is clear that the Commission has lagged in addressing the concerns noted above. And, although the Commission has an important oversight role regarding the self-regulatory organizations, it has in the main directed its attention to "upstairs" areas, largely sales practice matters rather than the market practices of these exchanges. This has led to the present bizarre situation, where ignoring whatever premium should adhere to the Commission's expertise, the primary inquiry into the operation of the NASDAQ market is by another government agency. The Commission has also, despite its frequent statements to the contrary, had only a distant and uncoordinated relationship with state securities regulators. In short, it is responsible for the lack of focused and coordinated securities regulation.

This can be remedied, and the Commission regain its centrality to the process, by extracting the premium obtained through the abilities of Commission personnel and the SEC's experience across the range of securities related subjects it deals with.

First, the Commission must differentiate between individual investors and investors who make individual trading decisions. Its role should be to protect the former by close oversight of the funds and advisors who are their fiduciaries, the capital responsibility of the entities which trade in the various markets, those markets themselves and a willingness to expand rather than restrict access to and use of information. Much of this refocusing could be accomplished by eliminating the Commission's Enforcement Division as an independent group and returning enforcement to the control of the various Divisions which create policy at the Commission.

The Commission should play no day to day role and expend little resources in looking after that minority of investors who trade on their own. (Well portrayed by the New York Times, October 22, 1995, which quotes one such "avid investor" as saying "My dream would be to stay home with a couple of TV sets with all these financial stations on and a computer to do my own trading.") To the extent these individuals, educated well beyond their predecessors, with access to enormous resources of information and trading on-line need looking after it can be done by the states. The Commission though can contribute federal standards as to sales practices and books and records requirements as well as consistency of application. It can also seek the continual upgrading of ethical standards. In this last regard, an excellent example is the industry committee inspired by Chairman Levitt which recently made recommendations on brokers' compensation.

STATE SECURITIES REGULATION

Since the advent of the federal securities laws state blue sky commissions have lacked a mission. As the size of offerings have grown and markets such as NASDAQ have come into existence the role of state securities regulators in the capital raising process has continually diminished. This is true even when, on occasion, states have enacted legislation to address some newly developed situation, i.e., New York State's Real Estate Syndication Law aimed at the concerns of a particular investment vehicle of the nineteen-sixties. (Being particularized, the dropping from fashion of the investment vehicle through simple investment economics necessarily results, after some time, in the reduction of related regulatory efforts.)

Nevertheless, even in its reduced state blue sky regulation remains an unnecessary inhibition on capital formation, providing little or even unwanted protection to the segment of investors who make individual speculative decisions. There should

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be though a useful role for the states in enforcing SEC standards for the sales practices of brokers and otherwise bringing actions under federal securities fraud statutes. This is the example set by New York, the nation's preeminent state in providing financial services. With the exception of the Real Estate Syndication law noted above, New York has long had solely a fraud based approach to its blue sky regulation.

SELF-REGULATORY ORGANIZATIONS

It is often said that as to broker-dealers and the markets they trade in American securities regulation is a self-regulatory process. Obviously, the existence of the states and the SEC's recent enforcement actions brought against certain national full-service brokerage firms shows this is not necessarily the case. In fact, the self-regulatory aims of the various exchanges throughout the country are, excepting the New York Stock Exchange, the NASD, and to a lesser extent the American Stock Exchange, market rather than customer driven. This is as it should be.

When the federal securities laws were enacted each of the stock exchanges had examination and enforcement mechanisms in place. These came about to ensure the protection of exchange members from the market practices and capital failure of other members and to some extent from these members' customers. (This latter concern was, of course, the original meaning of the New York Stock Exchange's "know your customer" rule (Rule 405).) However, the expansion of self-regulation to include customer related sales practice matters has not only created disparities of due process between exchange procedures and those of the states and the SEC but has blurred regulatory analysis. This is evident both in the present NASDAQ governmental inquiries and from the NASD commissioned Rudman report which recommended the division of the National Association of Securities Dealers into two entities, one reflecting membership, customer and sales matters and the other those of the NASDAQ exchange.

The role of exchanges in effecting "upstairs" sales compliance is both unnecessary and distracting. Neither the public, which makes individual investment decisions, nor industry registered personnel are well served by entities which among other items, lack subpoena power to pursue their investigation. The structure envisioned would reflect the exchanges' experience and knowledge by limiting their self-regulatory effort to financial examination of their members and matters involving their markets.

Mr. FIELDS. The Chair will now recognize Professor John Coffee, the Adolphe Berle Professor of Law at Columbia University. Professor Coffee.

STATEMENT OF JOHN C. COFFEE, JR.

Mr. COFFEE. Good morning. I want to say very clearly at the outset that I agree the time is right for reconsideration of the Federal securities laws in light of significant changes in the world's capital markets. There are basically four critical types of changes that have gone on since the passage of these laws in the 1930's.

Very, very briefly, they would include, one, the rise of institutional investors that now control a majority of the equity securities in the United States; two, the emergence of modern finance theory, which I think gives us a new perspective and a new lens through which to examine regulation; three, the SEC's own adoption of integrated disclosure and shelf registration which, as I'll say in a moment, does create some potential mismatches between statutory structure and evolving practices; and four, modern telecommunication. As others have noted, this and the computer revolution may make somewhat outdated old-fashioned ideas like the physical delivery of an actual document called a prospectus. Access may well be a modern substitute for delivery.

Now, those changes do justify reexamination. What I think they do not justify and where I have concerns is that in the process of statutory repeal, there may be some perhaps unintended relaxation

of the prohibitions against fraud and the protection of customers from conflict of interest. Nothing has changed in that area. The need for protection against fraud and conflict of interest will always be with us.

Moreover, in updating the Federal securities laws I think it's important to recognize that what is not broken does not need fixing and American securities markets remain the envy of the world, largely because of their transparency and their capacity for enlightened self-regulation. That transparency is very much the product, in my judgment, of the SEC's mandatory disclosure system.

And enlightened self-regulation, which I think is becoming more enlightened and we're seeing continued evolution—I would point with particular satisfaction to the recent work of Senator Rudman and his committee—all of which I think is desirable, and there are ways in which some of these provisions might restrict undesirably the ability of enlightened self-regulation to continue.

Now, very briefly, let me touch some high points. The 1933 Act. When that statute was passed, a public offering was a major event like birth, death or marriage. Today, under shelf registration, which intends to make possible immediate access to the capital markets, a public offering can be a more modest event.

And in that context, there is this mismatch between a statutory structure that requires underwriters and outside directors to conduct an elaborate investigation that may not be possible in those time-constrained circumstances.

This is an area where the SEC's advisory committee, of which I happen to be a member, will be making recommendations shortly. I don't want to anticipate those recommendations. It would be unfair to the committee. I will say, however, that I think the ability to implement any such regulations will be substantially dependent upon more exemptive authority being given to the Commission. I'm not sure that pure administrative rules, in the absence of some statutory exemption authority, will make it possible to create a meaningful safe harbor, either for underwriters or for outside directors, in the context of shelf registration.

So I'm not misunderstood, I want to make it clear. I think there is no need to change the law with respect to initial public offerings and other small issuances where I think the due diligence obligations of the statute are very important and very healthy.

Let me shift from 1933 Act, where I said exemptive authority is important, to a topic that has not been noted by the committee but I think should very much be on your list. This is the 1934 Act and the area of international securities listings. Foreign issuers often wish access to U.S. securities markets and to the U.S. exchanges. I think they have encountered some barriers, even in areas where the major securities exchanges would be very eager to list them.

This is a complex, sensitive area. I'm not suggesting that a one-sentence legislative fix is possible. I do think, however, that the world is beginning to agree on international accounting standards, and that consensus is healthy, and this committee's attention to this area and to the difficult negotiations that have gone on between the stock exchanges and the SEC in this area, might be beneficial.

And again, attention can often spur progress, and I think it might even be able to spur some timetables so that in the nearer future we might see many of the world's largest companies be allowed to list on the major New York securities exchanges.

I see my time is up. There are various other statutes that I would like to commend to your counsel's attention and in all these cases I think there is room for some reform, but some need to make sure that the rules against fraud are not relaxed. Thank you.

[The prepared statement of John C. Coffee, Jr. follows:]

PREPARED STATEMENT OF PROFESSOR JOHN C. COFFEE, JR.

INTRODUCTION

Statutory obsolescence is the fate of all legislation. Sooner or later, any statute will become outdated and confining. Now that the principal federal securities laws have passed their sixty birthday, it is timely to ask whether there are respects in which they should be updated or pruned. However, while statutes can grow old, some problems are timeless. Like death and taxes, fraud and conflict of interest will always be with us. Moreover, what is not broken, needs little fixing. American securities markets remain the envy of the world, and, as one who has recently studied Chinese, Czech, Russian and Taiwanese markets on location, the strength of American markets lies in their transparency and capacity for enlightened self-regulation. Thus, wholesale deregulation risks throwing the proverbial baby out with the bath.

With these cautionary comments in mind, let me turn to several areas where sensible deregulation is possible:

1. The Securities Act of 1933 (the "1933 Act")

Shelf registration is a modern phenomenon, dating from the early 1980s. It has worked well, but it fits awkwardly with the 1933 Act in one important respect. Because shelf registration contemplates repetitive, smaller offerings, timed to quickly catch market "windows of opportunity", it does not permit the same time for, or level of, "due diligence" as is possible in a major offering (such as an initial public offering or "IPO"). Both outside directors and underwriters may be unfairly exposed by the 1933 Act, whose Section 11 holds directors, underwriters, and certain experts (most notably, accountants) presumptively liable for any material misstatement or omission in the registration statement, unless they can satisfy a rigorous "due diligence" affirmative defense that requires them to demonstrate both a "reasonable investigation" of, and a "reasonable belief" in, the accuracy of all material facts in the registration statement. Time has shown the '33 Act to work very well for IPOs and certain other large offerings, but in the context of shelf registration offerings (which occur in time periods measured in hours not days), there may not be sufficient time for a "reasonable investigation".

Safe Harbor protective may therefore be appropriate within the special context of shelf registration. Although this topic is being considered by the SEC's Advisory Committee on Capital Formation and the Regulatory Processes (of which I am a member), there are limits on what can be done administratively. The SEC probably does not have authority to shift statutory burdens of proof under § 11 and may not be able to design a truly protective safe harbor (Rule 176 has certainly failed at generating much protection, and, based on admittedly only brief research, I have found no case that has even cited this Rule).

What kind of deregulation is desirable here? I would advance two concepts:

(1) The amount of due diligence required should be proportional to the size of the offering. In short, although due diligence is desirable (and modern law and economics confirms the desirability of "gatekeeper liability"), it is costly, and costs can exceed their benefits. The same level of due diligence required for a $1 billion equity offering should not be required for a $50 million trickle into the market.

(2) Implementation of this proportionality concept might be most simply achieved by granting the SEC exemptive authority. Or, if a brighter line standard is desired, the burden of proof might be shifted under § 11 (and the phrase "reasonable investigation" dropped) in the case of companies eligible for shelf registration. This would afford considerable relief to both underwriters and outside directors in this special, safer context.

At the same time, a balancing observation is necessary: I would urge the Congress to restore § 12(2) liability in the case of private placements. Private placements were subject to § 12(2) for misleading statements and omissions for sixty years until this

year when the Supreme Court decided *Gustafson v. Alloyd Co., Inc.,* 1115 S.Ct. 1061 (1995). Section 12(2) of the 1933 Act is considerably milder than § 11 and does not require a special "reasonable investigation." Simply put, there should not be a sharp disparity between the liability rules applicable to shelf offerings and private placements, but rather there should be a uniform standard, because typically it is the same purchasers (i.e., institutional investors) who are buying in both contexts. One does not want to create an incentive not to register, but such an incentive may exist today.

I will not discuss here the "company registration" proposals that the SEC's Advisory Committee may soon put forward (and which I expect to support), other than to say that they too could benefit from a general exemptive power in the SEC.

Finally, the Fields bill proposes limiting prospectus delivery to those investors requesting it. This may convert a mandatory disclosure system into an optional one. Unfortunately, those who fail to request may be those who most need disclosure. The better, more cost-effective technique may be to redefine "delivery" to include on-line computer services to which the investor has access.

The SEC has already begun to move in this direction, and it offers potentially much greater cost savings (most notably, for mutual funds).

2. The Trust Indenture Act of 1939 ("TIA")

There is indeed a plausible case for repealing much of this statute, as mandatory contract terms no longer appear critical when most bonds are purchased by institutional investors. But here again, the danger of throwing the baby out with the bath arises. The TIA also precludes amendments (without unanimous consent) of the indenture which reduce the principal obligation outstanding, reduce the interest rate, or extend the maturity date. In recent years, techniques have been developed by which issuers threatened with insolvency can coercively obtain consents to changes that are adverse to bondholders (principally by vote buying in consent solicitations). See Coffee and Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations,* 58 U. Chi. L. Rev. 1207. The TIA stands as the principal bulwark against these techniques. If it is to be replaced, some substitute is necessary, because even sophisticated investors are subject to coercion when collective action is difficult or costly.

3. Margin Rules

Briefly, I can understand the case for relaxing initial margin levels, but not for restricting the ability of SROs to establish maintenance margin levels. The NYSE has been in this business since well before the SEC was created. It would be an extreme step to prohibit self-regulation of the industry, by the industry, and for the industry.

4. Blue Sky Preemption

As Chairman Levitt has stressed, there is room for better coordination between state and federal regulators. Common standards have already developed by which to deregulate the blue sky process for the exchange-listed company. Fortune 500 companies tend to encounter few problems, and the real issue is the large IPO that underwriters wish to market nationally. Here, some respect must be given to federalism: one state may well wish to disqualify an offering that another will tolerate.

Today, state regulators have one advantage that the SEC lacks: a longer statute of limitations that is typically tolled during the period that the fraud remains concealed. Unless the Congress is prepared to re-arm the SEC with a longer statute of limitations, it would only compound the injury done to the SEC to similarly disarm state regulators by limiting them to Rule 10b-5 and a short statute of limitations.

5. Williams Act

While I have yet to hear a single corporation complain of overregulation from this source, the Williams Act does overregulate institutional investors who are not seeking corporate control. The United States Competitiveness Policy Council has urged some deregulation in this area, and I concur.

Mr. FIELDS. Professor Coffee, thank you very much.

The Chair now recognizes Mr. A.A. Sommer of Morgan, Lewis & Bockius, also a former Securities and Exchange commissioner.

STATEMENT OF A.A. SOMMER, JR.

Mr. SOMMER. Thank you very much, Mr. Chairman. I appreciate immensely the opportunity to appear before you and the subcommittee this morning. One of the problems of being the last in the line of witnesses is that everybody has said the good things. But I will try to avoid as much duplication as I can.

I think it's a very important undertaking that you are undertaking. While there is no crisis in our capital markets, no crisis in our regulation, there's certainly the need for a searching examination of the statutory structure. The changes in the markets that have occurred in the last few years have been detailed by others and the changes are coming with, if anything, more rapidity than ever.

I presently serve as chairman of the Public Oversight Board, which is principally a lay board that oversees the integrity of the audit process for public companies and a former member of this House, distinguished member, Mel Laird, is a member of that board. I am also vice chairman of the National Association of Securities Dealers and was a member of Senator Rudman's panel that recommended far-reaching changes in the structure and practices of the NASD.

I was a commissioner of the SEC from 1973 to 1976 when we made some significant strides in the direction of opening up markets to competition. We eliminated fixed commissions. We authorized the establishment of the CBOE, which was the first exchange upon which derivative products were traded.

I would commend to you the work that has happened in the past. A number of endeavors since 1961 have taken place which sought to bring the securities laws into greater synchronization with the needs of the times. I have detailed those in my prepared statement. I won't repeat that.

I would call your attention, however, to one of the most significant, and that was the 10-year effort that was undertaken under the sponsorship of the American Law Institute and the leadership of Professor Louis Loss to coordinate and bring together all of the statutes administered by the SEC. This was developed into a Federal Securities Code. We sought to get enactment of it by the Congress. Unfortunately, that did not happen. However, there is a committee print dated August 8, 1979 that incorporates this gigantic endeavor.

Several things in it that I commend to you. One of them was the fact that we had reached agreement with the SEC and with the State regulators as to where the line of demarcation should be drawn and an accommodation of all of those interests is incorporated in that committee print. And I would suggest that in consideration of the question of preemption, it might be well to go back and reconsider that.

The second thing is that I think the idea of company registration is one that was central to the Federal Securities Code and I would commend it to this committee. That would eliminate the necessity of multiple registrations of securities offerings, registration under the 1934 Act. It would simplify the procedures considerably and permit a great deal more flexibility on the part of the Commission in dealing with the disclosure and registration process.

I don't think that the changes need to be as extensive as proposed in the Code but it is something worthy of consideration.

Furthermore, I would recommend that, as has been done before, that the Commission's powers of exemption with regard to classes of securities, individual securities companies and classes of companies, also should be broadened, even beyond that which is provided in H.R. 2131. This would provide the Commission with the flexibility it presently does not have. It has made do with limited definitional authority and done a good job with that. However, it would be well to work out more clearly the authority it has to exempt.

I think there should also be a reexamination of the scheme of liabilities under the securities laws. Many of the advances that have occurred in the process of public offerings make it difficult for underwriters and outside directors to perform the sort of due diligence that was contemplated when the 1933 Act was adopted.

By the same token, there is more reliance in the security markets, which are huge, upon the disclosures under the 1934 Act. It may be that greater inducements to diligence in the preparation of the documents under that should be undertaken.

Certainly there is need for reexamining, as I indicated, the relationship of Federal and State regulation. I think the proposals that Chairman Levitt voiced at the annual meeting of NASAA should deserve consideration. They seem to me to have been carefully thought out and well articulated.

Finally, suitability. I think this is an area in which the recent rule of the NASD, which sought to deal with the problem of suitability and institutional investors, should be carefully examined. This was an effort to rely less on the size of the portfolio of the institutional investor and more upon the nature of the institutional investor, its sophistication, the existence of other advisers, and so on.

I think it is important that—if I may have one more second, I, like many people, am offended by the fact that very often highly sophisticated investors blame the brokers for their own risk-taking, but I think that there is a responsibility that should be reposed upon the industry itself and the professionals to assure that there is ample opportunity for institutional investors to know what they're doing.

Finally, I would urge that as the committee proceeds in this work it ought to keep its eye on the principal target, which is the protection of investors. We have an enviable record in this country of protecting investors and that is why so many companies and investors are drawn to this country, and I think that we should be ever conscious of the fact that we have a very subtle and well balanced statutory scheme which should be protected at all costs. Thank you.

[The prepared statement of A.A. Sommer, Jr. follows:]

PREPARED STATEMENT OF A.A. SOMMER, JR.

Mr. Chairman, members of the Committee: First, I would like to thank you for the opportunity to speak to this Committee with respect to one of the very important matters under consideration by this Committee. Second, I would like to commend you for undertaking an in depth study of federal regulation of securities law. We happily do not confront any sort of crisis with respect to the adequacy or administration of those laws, but I think it is timely to review them in light of the enor-

mous changes that are occurring in the securities markets in this country and throughout the world. The pace of change is ever quickening and it is fit and timely that the adequacy of the statutory framework of the securities laws be examined.

I am presently serving as Chairman of the Public Oversight Board, a body dominated by non-accountants which oversees the integrity of the audit process in connection with publicly held companies; one of the members of that Board is a distinguished former member of the House, Melvin Laird. I am also currently serving as Vice-Chairman of the National Association of Securities Dealers and was a member of the Special Panel chaired by former Senator Rudman which has recommended far-reaching changes in the governance and enforcement activities of the NASD.

I served as a Commissioner of the Securities and Exchange Commission from 1973 to 1976. During that time the Commission took actions which were far reaching and which profoundly changed securities markets. To name two, we undertook to abolish fixed commissions for securities transactions, thus subjecting those services to market forces, with profound consequences for the efficiency of markets and the securities industry, and we authorized the Chicago Board Options Exchange, which was the first market on which financially based derivatives were traded, an action that opened the door to the development of innumerable derivative instruments, which, properly used, have enhanced the efficiency of markets.

As you undertake this study of the securities laws, I would commend to you for consideration the work that has been done in the past looking to reform of federal securities regulation. As a result of these efforts which have been ongoing for over thirty years substantial changes have been made in procedures and processes which attend the regulation of securities in this country. Issuers now can in many cases register securities more easily and economically, affiliates can sell securities confident that they are acting legally, and private placements and other unregistered sales of securities can be done more expeditiously and with more assurance of the legality of the offering.

I would like to briefly describe some of these efforts. I would emphasize that in each instance the recommendations and their implementation wee the result of intensive and multi-partied discussion and debate; in the case of the Federal Securities Code, the effort continued for more than ten years.

In 1961 the Congress directed the SEC to make a study and investigation of the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations, including rules for the expulsion, suspension, or disciplining of a member for conduct inconsistent with just and equitable principles of trade.

While on the surface one might conclude the study was to be confined to self-regulation, in the words of the report which eventuated, "The wording of the law and its legislative history made clear that it contemplated a very broad study of the rules, practices, and problems in the securities industry and the securities markets."

Out of that broad mandate came the Special Study of Securities Markets in 1963 which reflected two years of work by about sixty-five people from a number of disciplines. This study was extensively implemented through amendments to the securities laws in 1964 which strengthened greatly the effectiveness of those laws.

The implementation of this Study carried over into another study done internally by the Commission under the leadership of then Commissioner Frank Wheat. This study, entitled Disclosure to Investors: A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts, made a number of recommendations to simplify the administration of the securities laws, most of which were adopted by the Commission.

By far the most searching reexamination of the securities laws was undertaken by the American Law Institute, an organization consisting of practicing attorneys, judges and academics. Under the leadership of Professor Louis Loss of the Harvard Law School and the preeminent securities law scholar of this era, a varied group labored from 1969 to 1979 to integrate the seven statutes administered by the SEC into a coherent whole, eliminating much of the duplication and inconsistencies that then, and now, characterize the statutory scheme. While the objective of this codification effort was the adoption by Congress of a "Federal Securities Code", unhappily that did not come to pass, although the Code was incorporated in a Committee Print of the House dated August 8, 1979.

The Code in that Print reflected the agreement of the SEC and the state regulators. Of particular interest in the light of one of the provisions of H.R. 2131 was the redefinition of the jurisdictional limits of federal and state regulation. As the discussion with regard to this progresses I would urge that the Code and its annotations be carefully studied.

Another noteworthy reexamination of a portion of the securities laws was the work of the Advisory Committee on Corporate Disclosure which I was privileged to

chair. This Committee, after two years of study and meetings, in its November, 1977 Report made far-reaching proposals to simplify the disclosure process and make it possible for many issuers to reduce considerably the costs of complying with the disclosure requirements. Happily most of these recommendations were adopted by the Commission over the next few years.

As the work of the Committee proceeds, however, it is well that it not lose sight of the fact that we have had in this country for over six decades an outstandingly successful system of securities regulation. As Senator Garn said in 1990,

> Our nation's securities markets have long been considered the fairest and most efficient in the world. This is not an accident of history. Our markets are efficient because they are unencumbered by artificial restraints or barriers. The perception that our securities markets are the fairest in the result of the vigilant enforcement of the federal securities laws by the SEC.

I have had the opportunity in recent years to consult with a number of governmental bodies concerning their securities laws—Taiwan, the Peoples' Republic of China, Trinidad and Tobago, the Republic of Fiji, Indonesia, and others. In every country, our system of securities regulation is looked to as the paradigm, the model, the system they would like to replicate. The Economist magazine, which in 1986 when the United Kingdom was in the process of reforming dramatically its securities regulation, inveighed against setting up anything like an SEC. However, in 1992, it did a 180 degree turnabout and concluded, "It is time to seek virtue elsewhere—in statutory rule by a single, independent body. Britain needs the equivalent of America's Securities and Exchange Commission."

The Advisory Committee on Corporate Disclosure which I mentioned grew out of the then increasingly common belief among economists that the mandatory disclosure system administered by the SEC had been rendered obsolete by modern economic theories and the work of market forces. That Committee, which included eminent economists, lawyers, accountants, securities analysts, business executives, and investors (not the least of whom was Warren Buffett) studied that question very carefully and concluded that

> . . . notwithstanding the arguments of economists and others that the efficient market hypothesis, the random walk theory and the strength of market forces, have rendered obsolete or unnecessary much or all of the disclosure system administered by the Securities and Exchange Commission, these arguments are not sufficiently compelling to justify dismantling the existing system at this time.

Mr. Chairman, members of the Committee, in my estimation that conclusion is as valid today as it was in 1977, and I would urge that the Committee not consider dismantling the mandated disclosure system that has served American investors so well for the last sixty years.

Having said that, however, measures can be taken to make the system more effective. One of these is company registration, a notion that was basic to the Federal Securities Code. Today a company wishing to make a public distribution of securities must register under the Securities Act of 1933 the securities that are proposed to be distributed and must separately register under the Securities Exchange Act of 1934 certain classes of securities that are publicly held. Company registration would open the door to much simplification of the procedures by which public offerings are made. While the Code would have replaced the registration requirements of the 1933 and the 1934 Acts with a comprehensive scheme implementing company registration, it may be possible to accomplish company registration without the elaborate statutory provisions in the Code, in a somewhat simpler manner with rule-making discretion in the Commission to flesh out the concept.

H.R. 2131 would give to the Commission to power to exempt "any security or class of securities" from the registration and prospectus requirements of the 1933 Act. I would urge the Committee to go further and adopt the approach of the Federal Securities Code and give the Commission the power to exempt any company or security or class of companies or securities from any of the provisions of the 1933 and the 1934 Act. While the Commission by the ingenious use of the limited powers it has which lend themselves to the task has created a number of sensible rules which in effect create exemptions, a clear cut power to exempt would permit much greater flexibility in Commission rule making.

Another area which the Committee may wish to consider is the scheme of liabilities under the '33 and '34 Acts. Without addressing any specific provision, it may be that these should be revised to reflect modern realities. The Commission sought to address some of these problems in Rule 176 which provides a limited "safe harbor" in connection with offerings. Perhaps the liability provisions should be revised to reflect the fact that often companies wish to go to market with a speed that

makes the prescribed due diligence almost impossible for underwriters and outside directors. They might also be revised to reflect the importance of diligence in the preparation of periodic filings with the Commission which provide the disclosure underpinnings of the secondary market which dwarfs the primary market in importance to the investor.

The relationship of state and federal regulation surely merits reexamination. The Code, as mentioned, developed, with the blessing of the North American Securities Administrators Association, new lines of demarcation. Over the years much has been done administratively to ease the burdens of multiple regulation, but it is well that a considered and thoughtful consideration of this topic be undertaken now. I believe the proposals which SEC Chairman Levitt put forward a few weeks ago at the annual meeting of NASAA were thoughtful and constructive, and I am pleased that NASAA has expressed the state administrators' belief in the importance of the matter by appointing a committee to study it.

I would address one last item in H.R. 2131, and that is suitability. I, like others, am offended when highly sophisticated investors seek to shove off on others the consequences of their own laxity and risk-taking. For many years the National Association of Securities Dealers has had a rule requiring that whenever anyone associated with a member of the Association (and that includes virtually everyone engaged in the securities business) makes a recommendation to a customer he or she must determine whether that recommendation is suitable in light of information he or she can secure concerning the investor's financial and tax status and investment objectives. Recently, recognizing that suitability in relation to institutional investors is considerably more complex, the NASD has amended its rule to prescribe numerous factors which should be taken into account when making a recommendation to an institutional investor. In the Preliminary Statement to the new rule, the NASD recognizes the fundamental responsibility of the securities industry members to their customers: "The NASD's suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct." The rule recognizes that the size of the portfolio of the institutional investor is not determinative of the scope of the responsibility of the broker; rather the emphasis is on whether the customer has the capability to assess the investment and the extent to which it intends to exercise independent judgment in evaluating a broker's recommendation. It is well to protect members of the industry from unwarranted claims, but it is also extremely important to expect of industry members high standards of professional conduct.

I would urge that the Committee study closely the revised NASD suitability rule and ponder whether it strikes the right balance between the protection of investors and fairness to members of the securities industry. In any event, I would suggest that the $10 million threshold in H.R. 2131 for determining the institutional investors who cannot enjoy the protections of suitability determinations is too low, many of those responsible for investment decisions in small institutions are often no more sophisticated than the individual investors who are protected by the NASD's suitability rule. And it should be remembered that institutional investors are usually investing the money of people of limited means who, were they investing directly, would have the protections of the suitability rules.

In closing, I would again commend this Committee for its initiative. Happily the Committee does not confront, as do many other countries, a regulatory system that has failed in protecting investors, hence it can spend the time and effort necessary to make the sort of comprehensive review that has preceded other reform efforts and that hopefully will precede the adoption of any legislation. The securities laws are a delicate balance of many interests and concerns; they should not be changed without thoughtful and necessarily time-consuming consideration and debate.

I would urge that in all it does the Committee have as its target increasing the protection of investors. In doing that, it will contribute significantly to the ability of corporations to tap our capital markets. It is increasingly apparent that, as investors have become more knowledgeable, they are ever more demanding that the markets in which they commit their capital not only be efficient, but that they be honest and well regulated. The markets of this country have helped not only American enterprises, but innumerable foreign ones as well, to raise huge amounts of capital. This is in large measure attributable to the fact that our markets have integrity, with a vigilant and knowledgeable regulatory authority in place.

Thank you very much for this opportunity to address this Committee. If, as your work progresses, I can be of assistance, I would be pleased to respond.

Mr. FIELDS. Thank you, Mr. Sommer. All statements will be included, in their entirety, in the record. And let the Chair immediately thank all of the witnesses for coming. I know some of you

have traveled great distances in inclement weather. The subcommittee is very appreciative.

Professor Coffee, let me start with you. Five minutes is not a lot of time and you talked about the need for the committee to look at foreign securities listings and perhaps some of the problems associated therewith, and I would be more than happy to receive any commentary that you have on that, particularly in written form.

But let me go to the points that I thought you were about to make. You said that other things needed to be considered by the subcommittee. Could you tick off the things that you were going to mention?

Mr. COFFEE. I went through a couple of them. I have an outline here and I'll go down the list. I think that areas like the Trust Indenture Act, for example. I understand that there's a strong case for repealing a provision that says the following contract terms have to appear in every contract.

That's out of date in the time of institutional investors. But there is still the danger of throwing the baby out with the bath. There's at least two things that I think are relevant in that statute. One is the requirement of an independent trustee at the time a company approaches insolvency, and I think that is something that has a real impact today. When you see a company getting near insolvency, its commercial bank will typically resign as trustee and appoint a much more independent trustee.

Second, that statute does not allow amendments that either reduce the interest rate, the maturity or the principal amount of the indebtedness outstanding. Institutions may be sophisticated but they're not immune from coercion, and there are coercive techniques used today to solicit exit consents, to force investors in circumstances of insolvency to reduce or change or modify adversely the terms of that provision.

So all I'm suggesting is even in an old statute like the Trust Indenture Act, there's about 10 or 15 percent of it that's very important and should be carefully examined.

When you get to margin rules, I again believe that the case for initial margin is probably weak today. It makes a lot of sense to look at the need for the case for repealing those provisions. But there is also a section of the draft bill that talks about restricting the power of SROs, self-regulatory organizations, from adopting any rule inconsistent with the Federal Reserve Board.

Frankly, the New York Stock Exchange has been regulating maintenance margin for the last 100 years. I'm not sure there's any need to fear industry self-regulation. Industry self-regulation rarely overregulates. And I think when the industry regulates for its own good it should not be prohibited, as some provisions of the margin rule sections would seem to do.

I certainly accept also there's a case for blue sky preemption but when you focus on the second level issues, the one advantage that blue sky administrators have on the anti-fraud playing field is that they have a longer statute of limitations that is told during the period that the fraud is concealed. Unless Congress is prepared to rearm the SEC with a longer statute of limitations, I think it would only compound the injury done to the SEC by a short statute of limitations if we were to disarm State regulators by limiting them

to a rule 10(b)(5) action in Federal court under a short statute of limitations.

So again, these are second level issues but they are quite important in terms of precluding——

Mr. FIELDS. The subcommittee looks forward to any other comments that you have, particularly in written form. But let me turn that question to the panel regarding Federal preemption. There was a report prepared by the Congressional Research Service dated July 18, 1995 and they did an estimate of the cost. And the paragraph, the operative paragraph is on page 5 of the report. It says, "Thus, for 1994 we arrived at an estimate of the total legal administrative costs of blue-skying securities issues of $260 million on the lower side and between $430 million and $600 million on the upper side." Do any of you have estimates concerning the costs related to compliance with Federal and State requirements, or would these sound in the ballpark to you?

Mr. COHEN. They certainly sound in the ballpark and probably low. I think what happens is that people don't take into account the intra-industry or corporate costs involved in compliance.

The issue is the one that Congressman Cox referred to and that is the reason and the only reason why the States are interested in this kind of blue sky merit regulation is because of the need to preserve it and keep it as a revenue-raising device.

The head of NASAA was very clear a couple of weeks ago in an interview in believing that without those revenues, the States would not fund the blue sky effort, and that's really the essence of this as to whether individual States are willing to pay for investors' protection that they may or may not believe necessary.

Mr. FIELDS. Any other comments?

Mr. SOMMER. I would only comment to this extent, Mr. Chairman. I think that while it is true with regard to blue sky activity related to already public companies, there is a role, I think, for blue sky regulation with regard to small offerings, offerings that may not be subject to SEC jurisdiction. It seems to me that there's legitimate State interest in those.

I will give as an example an intrastate offering. This is not subject to any registration under the SEC rules, under the securities laws, but I think a State may legitimately have a concern with the quality of that offering and the nature of its distribution, the compensation of underwriters and things of that sort.

So I think it's necessary to avoid painting with too broad a brush in that area.

Mr. COHEN. Mr. Chairman, Mr. Sommer might be able to tell us, because he's a vice chairman of the NASD, that in fact there is another level of review which the NASD imposes on IPOs, and that's through its listing standards. If the NASD determines that a company is not going to be listed on NASDAQ, its ability to do any size deal is totally gone. And that is an area that's also worth reviewing by this committee.

Mr. SOMMER. Well, the NASD reviews the compensation of underwriters, members of the association, in doing the deal, but they make no evaluation of the merits or the adequacy of disclosure on an intrastate offering, for instance.

Mr. FIELDS. The Chair's time has expired. The gentleman from Massachusetts, Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

Dr. Cox, you support the provisions of 2131 that repeal the reporting requirements of the Williams Act; is that correct?

Mr. CHARLES COX. Yes, I do.

Mr. MARKEY. During your tenure at the Securities and Exchange Commission you were called upon to vote on a number of enforcement actions undertaken in connection with suspected violations of the Williams Act; is that correct?

Mr. CHARLES COX. Yes, that is.

Mr. MARKEY. And the case involving, amongst others, Ivan Boesky and Michael Milken?

Mr. CHARLES COX. That's correct.

Mr. MARKEY. Can you tell us how you voted on those cases?

Mr. CHARLES COX. Yes. I voted to enforce the law. I had vowed to do that and I did that to the best of my ability.

Mr. MARKEY. Did you doubt the utility of the Williams Act at the time that you were voting for the enforcement action against those people?

Mr. CHARLES COX. Yes. I doubted the utility of certain provisions such as those reporting provisions because I did not view those as protecting investors against fraud, unless you define fraud as violating the reporting provision.

Mr. MARKEY. Did you speak out at that time about the unfairness, as you saw it, of the Williams Act being enforced against those gentlemen?

Mr. CHARLES COX. No, I did not view it as unfair to enforce the law, as written and as properly interpreted, in the same way that I wouldn't view it as fair not to state my beliefs if there's a discussion of revising the securities laws going on.

Mr. MARKEY. Did you always doubt the value of the Williams Act, even at that time?

Mr. CHARLES COX. No, I don't believe so. I think that through my experience at the Commission, as well as studies of the financial markets that I've done over time, have led me to the position that I stated today.

Mr. MARKEY. Now, one of the owners of your consulting firm, Daniel Faschell, recently wrote a book in which he suggests that by enacting the Williams Act, Congress was responsible for creating real criminals like Ivan Boesky, Dennis Levine and Martin Siegal. He also contends that Milken and Dulzarian, amongst others, were unfairly prosecuted under the Williams Act. Do you agree with those arguments?

Mr. CHARLES COX. No, I don't believe so, stated the way you do. I'm aware that Mr. Faschell has written a book but I haven't read that book.

Mr. MARKEY. Your firm has received substantial revenues from Michael Milken over the years, though; is that correct?

Mr. CHARLES COX. That may be correct.

Mr. MARKEY. And is it fair to say that most of the firm's business revolving around defending firms or individuals accused of some type of financial fraud?

Mr. CHARLES COX. No, I don't believe that's correct, Congressman Markey.

Mr. MARKEY. Does your firm or anyone associated with it continue to have any kind of on-going financial relationship with Mr. Milken?

Mr. CHARLES COX. I can speak for myself. I have no relationship with him. The only relationship I ever had was enforcing the securities laws and authorizing the SEC action against Mr. Milken. As far as other people, I don't keep track of any relations of other people at Lexecon.

Mr. MARKEY. So as you sit here today you have no knowledge of any other financial relationship between any of the other principals at your firm with Mr. Milken?

Mr. CHARLES COX. Well, keep in mind, Congressman Markey, I am not a principal of Lexecon and I have no knowledge of any of the principals' relationships, financial or otherwise, with anyone.

Mr. MARKEY. So you have no knowledge of what's going on inside your own firm in terms of those issues?

Mr. CHARLES COX. That's not correct. The way you stated the question was any financial relationships and I have no reason to believe there are any financial relationships with Mr. Milken.

Mr. MARKEY. Thank you.

Mr. Sommer, do you see a need for repealing the reporting requirements of the Williams Act?

Mr. SOMMER. I personally do not. I think the reporting requirements have served a very good purpose. I think that the original purpose of them was to give notice to the market as to whether someone was accumulating stock, what their intentions were with regard to it. That was to avoid the situation in which ordinary investors were denied a controlled premium. It was a very beneficial piece of legislation, in my estimation.

Mr. MARKEY. What are your views on the proposal to eliminate the prospectus delivery requirement?

Mr. SOMMER. Well, I think that's a much more complicated topic. I personally am opposed to that. I think the prospectus, particularly in the case of initial public offering, serves a very valid purpose, and the wide circulation of it, which is provided for by Section 5(b), provides an opportunity for the marketplace and investors to become acquainted with the company and to make available in the marketplace extensive information about it. So I think that provision should be continued.

Mr. MARKEY. Thank you, Mr. Chairman.

Mr. FIELDS. The gentleman's time has expired. There will be a second round of questions.

The gentleman from New York, Mr. Frisa.

Mr. FRISA. Thank you, Mr. Chairman.

I'd like to direct this to Mr. Beese, if I could. The vast majority of States, including the dominant State of Delaware, have powerful laws that act as nearly absolute deterrence to hostile takeovers. Furthermore, Delaware targets can use poison pills to defend against most hostile tender offers.

Could you comment about whether or not these tools have rendered hostile takeovers virtually impossible to execute unless the bidder first obtains the approval of the target management, so that

the poison pill is redeemed and the State law is rendered inapplicable?

Mr. BEESE. Well, Congressman, clearly hostile takeovers are possible. And, in the context of this discussion about the Williams Act, I was delighted to hear the Chair's characterization of where discussions are regarding the Williams Act.

The Williams Act provides, I think, a very valuable speed bump for dissemination of information and I think the concept of speed bumps has worked well now in regard to the markets, with regard to dissemination of information. And, in fact, the concept of a speed bump may also work very well on another topic that has been mentioned here today, and that is the shelf registration process, again, to allow adequate time for markets and individual investors to disseminate information.

The interaction between the Williams Act and the individual State corporate laws is complex and that is one of the areas that certainly should be reviewed in this dialog of the top to bottom review of State securities acts. But in direct response to your question, hostile takeovers, I think you can clearly engage in them today.

And one other aspect of the review of the Williams Act should be the ability to synthetically circumvent the reporting requirements of the Williams Act by accumulating stock in ways other than are required for direct reporting under the Williams Act.

Mr. FRISA. I appreciate that. Of course, as we know, our bill, 2131, doesn't eliminate the Williams Act but rather, would streamline some of the reporting requirements required under 13(g). Do you see that as a good direction to move toward?

Mr. BEESE. Yes, very strongly. Not only streamlining some of the reporting requirements but again, it has become increasingly easy to circumvent synthetically, by the use of derivatives, OTC derivatives, to accumulate synthetic positions that don't necessarily fall under the reporting act.

One of the great outcomes of this exercise would be to make sure that the regulated markets maintain the market share that they have today and that we are flexible enough in our regulations so that we can keep this activity within the regulated markets and not have it synthetically go outside of the regulated markets and circumvent the regulation, which is intended to protect the markets.

Mr. FRISA. Thank you. Thank you, Mr. Chairman.

Mr. FIELDS. The gentleman's time has expired. The gentleman from Michigan.

Mr. DINGELL. Mr. Chairman, I thank you. Mr. Chairman, I'd ask unanimous consent that I be permitted to insert my opening statement in the record.

Mr. FIELDS. Without objection.

[The prepared statement of Hon. John D. Dingell follows:]

PREPARED STATEMENT OF HON. JOHN D. DINGELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

I would like to quote the first two sentences of Chapter 5 of Louis D. Brandeis' book *What Publicity Can Do*: "Publicity is justly condemned as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light

the most efficient policeman." I firmly believe that this essential truth remains as operative today as when Brandeis wrote these words decades ago.

How have we carried out this truth in the national interest?

Since its creation in 1934, the Securities and Exchange Commission has been charged with protecting investors and maintaining fair and orderly markets. The SEC performs this essential function with a modest staff and limited resources, operating in partnership with the private sector and self-regulatory organizations rather than through pervasive direct regulation. As a consequence, the U.S. securities markets are widely regarded as the deepest, most liquid, and fairest markets in the world. They serve the needs of more than 12,000 public corporations, raising capital to support new industries, create jobs, fund research and development, and support growth for the future. In 1994 alone over $800 billion of securities were sold in our markets. Capital was raised by both institutional investors (including mutual and pension funds) and private individuals. Almost one in three American households participate in the U.S. securities markets, directly or through mutual funds.

Today—in the midst of a Government shutdown and impending default on the national debt—we begin an examination of the federal securities laws underlying the world's strongest and most liquid capital markets. Legislation has been put on the table in aid of that review.

This legislation (H.R. 2131) would, among other things, eliminate key elements of the so-called Williams Act which gives companies and investors notice of takeover attempts. This would turn out the lights on this activity, and return the country to the days of the "Saturday night special" of sneak attacks by corporate raiders. It would also repeal key provisions of the Federal securities laws used to put Ivan Boesky and Michael Milken in prison.

The legislation would also repeal the Trust Indenture Act's important protections for debtholders. The purpose of this law is to protect investors in publicly offered debt securities by providing for an independent trustee to act on debtholders' behalf in the event of default. In 1990, Republican-initiated legislation modernized the Trust Indenture Act, making its proposed repeal now very curious indeed.

The Fields bill also would drastically curtail state securities laws and limit state securities regulators to enforcing Federal laws and standards. It would eliminate the requirement that investors be sent a prospectus before they buy newly offered securities. It would limit inspections of brokerage firms' books and records for rule violations and release brokerage firms from liability for recommending unsuitably risky securities to institutional customers such as municipal governments and pension funds. And it would reduce the number of SEC commissioners to three from five and fundamentally change the SEC's mission from "investor protection" and "the public interest" to requiring the SEC to take into account "promotion of efficiency, competition and capital formation."

We will hear testimony today that our system of securities regulation is the envy of the world and has played a vital role in maintaining the health and integrity of the U.S. financial markets. We will also hear testimony that that same regulatory system "resembles an archeological dig;" is "inefficient, redundant and excessively costly" and has become "a significant threat to the competitiveness of the U.S. markets." One statement that I read this morning even proposes that we eliminate the SEC's Enforcement Division and goes on to state that: "The Commission should play no day to day role and expend little resources in looking after that minority of investors who trade on their own."

My colleagues, this bill is a bad bill. It goes too far. I am inserting in the record, as part of my statement, (1) a letter that I received from my State's Corporation and Securities Bureau expressing "very strong opposition to H.R. 2131" and (2) noteworthy *Los Angeles Times* and *Money* articles on the bill's most significant defects.

Let me make this crystal clear: I will gladly participate in a review of our current regulatory system with the view toward improving its operation in the public interest. I will not participate in a review that undermines the Public interest and the protection of investors. Our markets run on trust and confidence. And, as Robert J. Samuelson noted last week in the *Washington Post*: "trust rests on faith that government regulators will supervise the complex payments system and police for fraud and financial failure. The idea is to prevent shady or insolvent operators from destroying confidence by making commitments they can't (or won't) keep."

STATE OF MICHIGAN,
DEPARTMENT OF COMMERCE,
November 7, 1995.

Honorable JOHN D. DINGELL,
U.S. House of Representatives,
2328 Rayburn House Office Building,
Washington, DC 20515-2216.

RE: Preemption of State Investment Regulation under H.R. 2131

DEAR CONGRESSMAN DINGELL: As the Director of the Corporation and Securities Bureau for the State of Michigan, I am responsible for administering and enforcing the State's laws designed to ensure investor protection and the efficient functioning of the capital markets at the grass roots level. As such, I am writing to express my very strong opposition to H.R. 2131, the "Capital Markets Deregulation and Liberalization Act," introduced in July by Rep. Jack Fields.

This legislation to overhaul federal securities laws includes provisions that effectively would eliminate the crucial investor protection benefits of state securities regulation. At the same time, the bill would deny to Michigan small business people the resources and assistance of our agency.

It is our belief that the bill would have the following unnecessary and highly negative consequences:

- Effectively eliminate state securities programs from a role which critical to maintaining the integrity of the marketplace. Although the bill indicates that state agencies could continue to enforce anti-fraud provisions of their statutes, the underpinning of state effective enforcement capacity would have been eliminated. This will ultimately leave a large segment of the marketplace extremely vulnerable since there is no possibility that federal authorities will be inclined or capable of filling the void involving what they consider small transactions.
- As a result, a reduction in market integrity and small issuers will find it more difficult to obtain capital through public offering or private placements. This would occur just at a time when the states are discussing significant efforts to make capital more accessible than ever through offerings on a state and regional basis.
- Michigan, like many states, has come to the realization that an aggressive investor education effort is essential to the protection of the investing public. Therefore we have expanded our efforts in this area and will be introducing additional programs during the coming year. H.R. 2131, because of its overall impact, will threaten the agency's capacity to undertake these efforts.
- State oversight of investment advisers, securities broker-dealers and their agents would be eliminated by H.R. 2131 despite the fact that their activities are significantly keyed to the local investor. There is little likelihood that federal authorities could possibly provide an effective mechanism of oversight at the local level comparable to that provided at the present time by the states. This is at a time when the number of registered professionals are increasing dramatically, and the reliance that the public places on the investment transactions and advice provided by these professionals play a critical role in the financial future of an increasing percentage of the population. The federal authorities have neither inclination or capability to provide reasonable oversight of these local activities. As an example note that the SEC is on record as indicating that its audit cycle for investment advisers is in excess of 30 years. The SEC has also indicated that the smaller investment advisers should be under state rather than federal oversight.

The states have made major efforts to promote a uniform national marketplace. The notion that there is duplicative or unnecessary state-level review of initial public securities offerings is a myth that ignores substantial recent state advances. Today, securities listed on major exchanges (e.g., New York Exchange, American Stock Exchange, etc.) and the upper tier of NASDAQ, as well as many issues listed on regional exchanges, are free of any state-level review. The issues reviewed by the states generally are those of smaller or low-grade offerings where investor protection concerns are the highest. H.R. 2131 would deny to state securities regulators this important role. Furthermore, the legislation may create a number of "regulatory black holes," such as offerings of $1 million or less, that currently are scrutinized only by our agency.

The State of Michigan has over the years attempted to develop mechanisms which assist the small entrepreneur in the raising of needed capital while preserving the integrity of the marketplace, that's the ultimate source of that capital. The Corporation and Securities Bureau adopted a Corporate Equity rule over ten years ago to assist the small business person. Currently the State has pending a rule to adopt

the Small Corporate Offering Registration which will tie in to federal exemptions and further facilitate the small business person's ability to raise capital. As previously indicated, we are also looking at additional mechanisms by which state's can serve as a catalyst for raising capital at the local and regional level by legitimate small businesses.

Finally I would like to note that this letter is not intended to indicate that we are opposed to change. I firmly believe that there may well exist real opportunities for the states, along with the federal government, and self regulatory organizations to examine the regulatory framework and make improvements which benefit both the investor and the business community. This may result in the State's ceding certain roles and responsibilities to their federal counterparts and the federal regulators doing the same in other areas. A determination of what is best for the overall community should be the result of reasoned examination of the system. While we firmly believe that the Securities and Exchange Commission does an outstanding job, and is critical to this nations participation in the global marketplace that is developing, in the final analysis a significant segment of the marketplace is small and local in nature. The system must be preserved in a manner that assures that our marketplace, which is already the envy of the world because of its integrity and capacity, raise capital and continue to be a model for the world.

The North American Securities Administrators Association has called for a Blue Ribbon Task Force which includes former and current SEC commissioners as well as representatives from major brokerage and other industry interest to review the current regulatory scheme and make recommendations for change. It's my belief that the nation would be well served to wait until that review is completed before proceeding with irrevocable changes to a system which isn't in a crisis but by all accounts is considered the best in the world. I applaud Representative Fields for causing us to look at changes which may be necessary in order to make certain that the system not only remains vital but increase efficiency and have the ability to address a changing global market place in the future. But such change should be well considered and calculated for success. The consequences of failure to our economy and the individuals who tie their future investments to the marketplace are too important for anything less.

If you have any questions or need additional information, please do not hesitate to contact me at (517) 334-6213.

Sincerely,

CARL L. TYSON,
Director, Corporation & Securities Bureau.

cc: Kathy Wilbur, Acting Director, Department of Commerce; LeAnne Redick, Director, Governor's Washington D.C. Office

LOS ANGELES TIMES, THURSDAY, SEPTEMBER 14, 1995
D1

How Fields' Dream to Cozy Up to Wall Street Backfired

■ Legislation: The lawmaker's securities regulation bill is being rebuffed en masse by the very executives he sought to please.

By SCOT J. PALTROW
TIMES STAFF WRITER

NEW YORK—Just over a month ago, a former top aide to Rep. Jack Fields (R-Tex.), chairman of the House subcommittee on telecommunications and finance, placed a confidential call to business executives, to explain the ins and outs of a bill that proposes the most drastic changes to the nation's securities laws since the Great Depression.

"A bill this controversial is unlikely to be passed" during the current Congress, assured Stephen A. Blumenthal, who until May was finance counsel to Field's subcommittee and had helped in the early planning of the so-called Fields Bill.

He asserted that the bill wasn't seriously meant to pass but was a gesture aimed at ingratiating House Republicans to Wall Street. Blumenthal said that the bill is House Republicans' way of saying: "Here, Wall Street, look what we want to do for you."

However, a bootleg tape of Blumenthal's candid remarks in a conference call to clients of his new employer, a consulting firm called the Washington Research Group, quickly became a hot property in Washington, especially among the bill's opponents. The recording has also emerged as perhaps the most embarrassing in a string of mishaps surrounding Field's efforts to woo Wall Street by attacking securities regulation.

Introduced by Fields and co-sponsored by seven Republicans on the subcommittee, the bill's stated purpose was to ease capital formation in America by getting big government off the backs of brokerage firms and investment banks.

But many provisions of the bill took Wall Street by surprise. Unexpectedly, Fields is

Please see FIELDS, D5

LOS ANGELES TIMES

FIELDS: Reform Bill Is Rebuffed by Wall Street

Continued from D1
being rebuffed en masse by the very executives he sought to please. Although Wall Street ardently desires specific reforms of securities regulation, the executives have expressed concern that the bill is so broad and radical that it might undermine confidence in U.S. securities markets. They also fear that a backlash against it may derail the drive for more limited reforms.

"We have a system that's the envy of the world," largely because our regulatory system has inspired global confidence in U.S. markets, said Theodore Levine, general counsel of PaineWebber Inc., the nation's fourth-largest brokerage firm.

Levine, once a senior lawyer in the Securities and Exchange Commission's enforcement division, said he is expressing a personal opinion and not necessarily that of PaineWebber. But, echoing a sentiment expressed by other Wall Street executives, he said the bill "is really fixing something that isn't broken."

The reaction has been so strong that Fields is backpedaling. In an interview, he confirmed that "we've heard some very negative comments" from Wall Street executives, although he maintains there is wide support for reforming the major securities laws passed in the 1930s. But he said he may back down on major provisions in the bill.

"I am not locked in that we have to do any or all of the things" in the bill, he said. "It is important for you and everyone else to understand that we are not going to compromise market security."

The "Fields Bill"

Officially known as the Capital Markets Deregulation and Liberalization Act of 1995, major provisions would:

- **Drastically curtail state securities laws,** and limit state securities regulators to enforcing federal laws and standards. For example, states would be prevented from having tougher standards than the federal government has for licensing individual stock brokers.
- **Release brokerage firms from liability** for recommending securities that may be unsuitably risky for institutional customers, such as municipal governments and pension funds.
- Reduce the number of Securities and Exchange Commissioners to three from five, and **fundamentally change the SEC's mission.** Currently, all SEC decisions must be consistent with "the public interest" and "investor protection." The bill would additionally require the SEC to take into account "promotion of efficiency, competition and capital formation."
- **Eliminate most of the Williams Act,** which protects corporations from hostile takeovers carried out through secret raids on their stock. The Williams Act requires public disclosure when any investor intends to take over a company or acquires 5% or more of the company's stock.
- **Repeal the Trust Indenture Act of 1939.** The law protects investors in corporate bonds, by giving an independent trustee detailed responsibilities for looking out for their interests if a company defaults on its bond payments.
- **Eliminate the requirement that investors be sent a prospectus** before they buy newly offered securities.
- **Limit inspections of brokerage firms books** and records for rule violations. The bill would require that only one stock exchange or the National Assn. of Securities Dealers would have responsibility for inspecting each brokerage firm. Currently, more than one exchange examines larger firms' records.

—SCOT J. PALTROW

Los Angeles Times

Fields contended that he never meant it to pass in its original form, stating that it was simply intended "to get the debate going." He added: "After the Democrats being in power for 40 years, I have a responsibility to put everything on the table."

Under Speaker Newt Gingrich (R-Ga.), House Republicans have won a reputation for tight organization and being able to ram through legislation. But the drama surrounding the Fields Bill shows that their efforts to rewrite the nation's securities laws are not yet as well polished.

What went wrong?

For starters, Congressional staffers said Fields' preparation of the bill was unorthodox and marked by unusual secrecy. Especially on bills that propose to overhaul major sections of federal law, Congressional drafters typically consult the agencies involved, such as the SEC, and other outside experts, to avoid mistakes and unforeseen consequences.

Although the subcommittee early on had solicited suggestions from Wall Street firms and other groups, and had alerted the SEC that a reform bill was being considered, the Republican staff consulted no one during the actual drafting. Fields confirms this but declines to offer an explanation, instead insisting that the SEC and others had adequate chance to give input.

The key drafter was someone who had had only limited experience with securities laws, people close to the subcommittee say. The bill was drafted almost exclusively by David L. Cavicke.

Cavicke, 34, joined the House Commerce Committee, which includes Fields' subcommittee, at the end of May as Blumenthal's successor as finance counsel. Cavicke's experience with securities law had been limited to three years as an associate with New York law firm Milbank Tweed Hadley & McCoy, during which he worked for the firm's banking department and spent much time on pro bono work unrelated to securities, lawyers at the firm confirmed.

Wall Street executives are scratching their heads about where several major provisions in the bill came from. But Congressional sources say the mystery can be explained by Cavicke's pet peeves.

For example, there is an especially contested provision that would repeal the Williams Act, which protects corporations from surprise takeovers through secret raids on their stock. Marc E. Lackritz, president of the Securities Industry Assn., the Wall Street trade organization that has lobbied hard to slash some regulations, said, "I've not found anybody yet that's supportive of repealing the Williams Act."

Similarly, the bill calls for abolishing the seemingly obscure Trust Indenture Act of 1939. Although few investors have heard of it, the act for 45 years has provided the backbone for confidence in the corporate bond market, protecting investors' interests if a company defaults. Wilbur L. Ross Jr., senior managing director of investment bank Rothschild Inc., said he knew of no one on Wall Street who favored abolishing the act.

People close to the Republican staff of the subcommittee said Cavicke put these provisions in, based on personal unpleasant experience while toiling as a young associate at Milbank Tweed. Cavicke sometimes worked late into the night complying with what he considered unnecessary, technical requirements of the Williams and Trust acts.

Cavicke declined to answer any questions about his role in drafting the bill. "As a matter of policy, we [Congressional staffers] don't comment on the record," he said.

The bill also includes a provision banning state governments from regulating investment advisers, giving all responsibility instead to the federal government. In their haste to draft the bill, Fields and his staff failed to notice that Sen. Phil Gramm (R-Tex.) had already proposed doing just the opposite, giving all responsibility to the states. Gramm's support as chairman of the Senate subcommittee on securities would be crucial to ultimate passage of the Fields bill. Staff members said Fields is now ready to endorse Gramm's stand.

Washington lobbyists and Wall Street executives said Fields probably could have avoided some of these pitfalls if preparation of the bill had been more open. But some aides to subcommittee members said Fields was so insistent on secrecy in drafting the bill that the operation took on the feeling of planning for a commando raid.

Democratic staff members of the subcommittee said they weren't given any preview of the bill, and said they believed they were deliberately misled that it wasn't going to be introduced until this fall. The SEC and state securities regulators were given no warning that the bill was about to be filed.

Although Fields denies there was any secrecy, Congressional sources contend that Fields was anxious to orchestrate the filing to make sure he got credit for a major securities reform bill. In particular, they said he wanted to keep from being upstaged again by an upstart freshman on his subcommittee.

Just 10 days earlier, Fields had delegated some responsibility to subcommittee member Rep. Daniel Frisa (R-N.Y.), a first-term Congressman, to help review possible reforms of the SEC as Congress considers the SEC's budget. Frisa would seem an unlikely candidate to evaluate the finer points of securities law—he is not a lawyer, and his limited experience with business before entering politics included some years as a salesman and assistant manager at Fortunoff department store on Long Island. In an interview, Fields insists that he had only asked Frisa "to work with me."

But without consulting Fields or Commerce Committee Chairman Thomas J. Bliley Jr., Frisa on July 17 issued press releases headlined, in big letters, "Frisa to Spearhead SEC Reform." In it, Frisa announced that "he will lead a Commerce Committee review of the SEC." Another was headed "Dan Frisa: Wall Street's Congressman." Congressional staffers said Fields was furious about Frisa's unauthorized grab for credit.

Fields denied that Frisa episode had anything to do with the way the Fields bill was introduced. But he confirmed that "when I saw press releases saying he was going to spearhead the effort, we did talk about that and he apologized."

Frisa didn't respond to more than six messages left by The Times seeking comment.

However, no sooner was the bill introduced than the effort suffered a major blow from someone else who had been inside the Fields camp: Blumenthal. In the taped conference call he suggested that the bill was meant to ingratiate House Republicans with Wall Street.

"It's a way of them showing Wall Street that there's a difference between Republican and Democratic control of the House of Representatives," Blumenthal said. Some critics, including state securities regulators, contend that means the bill was intended primarily as a Republican fund-raising tool.

Fields confirmed that he was angry about the conference call. "He spoke as a private citizen" Fields said. "In my view his analysis is absolutely wrong." Fields acknowledged that the leak of the conference call may have hurt the bill's prospects.

Blumenthal declined to be interviewed but faxed a copy of a letter in which stated that "it is our position that Congressman Jack Fields is engaged in a historic undertaking of enormous benefit to the country." He also sent a note to The Times asking that it not quote from the tape because he said it is copyrighted.

Meanwhile, a proposal in the bill to eliminate most state securities laws has evoked a storm of protest from state securities regulators and investors groups. State regulators have been in the vanguard of cracking down on major frauds involving small investors, taking the initial lead, for example, in prosecuting penny stock violations and the massive Prudential Securities limited partnership fraud. The North American Securities Administrators Assn., the national organization of state regulators, has said it views the bill as an attempt to eliminate state oversight of Wall Street firms.

The reaction has left some Wall Street executives fearing an unintended consequence of the bill—that state regulators, anxious to prove their worth, may step up or more publicly advertise actions taken against Wall Street firms.

Fields denies that the bill was intended to gut state securities regulation, and signaled he is ready to water down the provision. "We'll sit down with the states and try to work through a compromise," he said.

How Washington could tip the scales agains investors

Congress now wants to roll back securities regulation so radically that small investors may no longer get a fair shake. **by Ruth Simon**

DESPITE MORE THAN AN OCCASIONAL SCANdal or two, the highly liquid and reliable U.S. securities markets remain the envy of the world. Nearly a third of all American families continually demonstrate their faith in the market's basic fairness by investing their savings in stocks, bonds and mutual funds.

But the legal safeguards individual investors like you have come to count on are now under attack in Congress. This summer, overwhelming majorities in both the House and Senate passed litigation reform legislation that makes it easier for white-collar criminals to get away with cheating investors (see In Your Interest on page 9). Now comes a potentially more serious threat: Rep. Jack Fields Jr. (R-Texas), chairman of the powerful House Telecommunications and Finance subcommittee (shown at right), has introduced a bill (HR 2131) that among other things would eliminate state laws protecting investors and reduce the information investors receive from companies. "On the whole, I don't see anything in the legislation that's good for investors," says recently departed Securities and Exchange Commissioner Rick Roberts, who was nominated by President Bush in 1990.

"On the whole, I don't see anything in the legislation that's good for investors."

—Rick Roberts, a former commissioner of the SEC

The Fields bill strongly reflects the anti-regulatory ideology now gripping Congress. It's also a key piece of legislation—the centerpiece of what House Commerce Committee chairman Thomas Bliley Jr. (R-Va.) calls "a fourfold effort in the securities area to lower costs for capital formation." Here are the other three elements of Washington's assault on investor protection:

- The litigation legislation (HR 1058 and S 240) mentioned above would, for one thing, make it legal for executives to overhype their company's prospects.
- A plan to revamp how the Securities and Exchange Commission is funded would also freeze its $297 million budget this year, making it impossible to add 50 more mutual fund inspectors as planned.
- A "top to bottom" review of the SEC by freshman Rep. Dan Frisa (R-N.Y.) could diminish the agency's power.

The Fields bill remains the key, however, because it would

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FIELDS' AGENDA

- ☑ Scrap state laws that protect investors.
- ☑ Give less information on new stock offerings.
- ☑ Delay disclosure of possible takeovers.

Top 10 contributors

Securities, banking and insurance PACs who want fewer investor safeguards have given Fields more than $220,000[1] since 1993. The top 10:

J.P. Morgan & Co.	$20,000	American Bankers Association	$10,000
Citicorp	11,000	American General Corp.	8,000
First Boston	11,000	Chemical Bank	7,500
NationsBank	11,000	Goldman Sachs & Co.	7,500
Merrill Lynch	11,000	Investment Company Institute	7,000

Notes: [1]Includes donations related to Fields' failed 1993 Senate race. Source: Federal Election Commission

fundamentally shift power from Main Street to Wall Street. To get a sense of how enthusiastic Wall Street is about Fields, consider this: Since becoming the top-ranked Republican on the Telecommunications and Finance Subcommittee in 1993, he has received more than $220,000 in political action committee contributions from securities, banking and insurance groups, according to Federal Election Commission records. And Bliley and Frisa have gotten tens of thousands of dollars as well (see the tables).

Fields' legislation would hurt investors in four ways:

› The power of state securities regulators, who are generally more protective of investors than federal authorities, would be greatly diminished.

› Investors interested in a stock offering would get only an incomplete preliminary prospectus, or none at all, unless they specifically requested the final SEC-approved prospectus they get automatically today.

› Companies that accumulated a large block of another firm's stock would no longer be obligated to quickly disclose that fact, leaving investors in the dark.

› Reckless brokers could pitch ill-suited investments to pension funds, mutual funds and other large institutions without facing liability for subsequent losses.

To better understand what the legislation could mean to you, MONEY talked to more than two dozen policymakers and securities experts, including three former SEC commissioners. Our conclusion: The reforms that Fields and his colleagues are pushing could leave shareholders poorer and our markets weaker. Warns Joel Seligman, the respected dean of the University of Arizona College of Law: "They're playing Russian roulette with investor confidence."

The good news: Most experts say it's unlikely that the Fields bill as it stands now will become law this year. It has no Senate sponsor, though Phil Gramm (R-Texas), chairman of the Senate's securities subcommittee, says he supports its overall approach. In addition, White House counsel Abner Mikva told MONEY: "I would be very surprised if the Administration was not opposed to the bill in its present form. They're throwing out some very important regulatory procedures to satisfy this notion that all government is evil."

Fields concedes that his proposals are subject to change. "I don't think anything is written in stone," he says. Furthermore, Fields, an attorney who helped run his family's funeral home and cemetery business before joining Congress 15 years ago, insists that he's not out to bury "basic investor protections." He contends that overregulation makes it more expensive for companies to raise money in the U.S. than in Europe, therefore leaving our corporations at a competitive disadvantage. "I think the people who will applaud this bill," he says, "are people who see much of what is in securities policy today as ludicrous, duplicitous and extremely costly."

Not everyone buys that argument. Securities experts say that the high cost of raising money in the U.S. is actually a byproduct of our financial system's strength, not a sign of its weakness. Simply put, the legal safeguards have helped convince millions of Americans to invest in U.S. markets—and that means companies here can raise more money from an enormous pool of capital. "In Europe you don't find individual investors in the stock market," explains John Coffee, a Columbia University Law School professor specializing in corporate and securities law. Moreover, with acquisitions, stock offerings, share prices and trading volume all at or near record levels, it seems dubious to argue that our markets need such a radical reform.

One interested party that has been conspicuously silent about the Fields bill is the SEC. Chairman Arthur Levitt, who is well aware of Congress' power over his budget and operations, was largely left out of the drafting of the legislation, yet he has not criticized it. In a statement provided to MONEY, he said that "as we analyze the bill going forward you can be sure our touchstone will be the protection of individual investors."

He may need a small mountain of touchstones, even though some of Fields' ideas merit consideration. For instance, the SEC should be allowed to exempt companies from outdated securities laws. Also, individual states shouldn't tell fund companies what to say in their prospectuses; the SEC already does that.

But on the whole, Fields' legislation tips the scales heavily against investors. Here's MONEY's assessment of the bill's four most troubling proposals:

› **Eliminate state securities laws.** Nowhere are the interests of small investors more at risk. Specifically, the bill would override every state securities law that offers greater investor protections than federal laws. The lower federal standard would be the national standard, though states would be able to register and inspect brokers. Boston securities lawyer David Shellenberger says that requiring the states to enforce only federal rules would be a mistake. "It would be a nightmare for investors if they didn't have the protection offered by state agencies," he says.

Assuming the states react logically by cutting enforcement staffs, the SEC, which maintains only five regional offices, would get overwhelmed with potential cases. Says former SEC chairman David Ruder, a Reagan appointee: "It would be a disaster for the Republican party to take steps to emasculate the regulatory process and then find that the SEC has a crisis it can't handle because there's not enough staff, budget or power."

Make it tougher for investors to sue companies and brokers.

Top five contributors

Securities, banking and insurance PACs have given more than $125,000 to Bliley since 1993. The biggest donors:

American Bankers Association	$7,000
J.P. Morgan & Co.	5,000
NationsBank	5,000
Mutual of Omaha	5,000
Independent Ins. Agents of America	3,800

Source: Federal Election Commission

Strip the SEC of some of its regulatory power.

Top five contributors

Frisa has received more than $35,000 from securities, banking and insurance PACs since 1993. The five biggest:

Natl. Assn. of Life Underwriters	$3,000
American Financial Services Assn.	3,000
American Bankers Association	2,500
Citicorp	2,500
Merrill Lynch	2,500

Source: Federal Election Commission

Like cops who walk a beat, the states are often the first to spot problems and to develop new laws that tackle them. In 1986, for instance, Utah enacted tough penny-stock rules aimed at curbing "blind pool offerings." The pools, which are often vehicles for fraud, let stock promoters raise money without a specified purpose. The result: Blind pools registered in the state sank from 145 in '85 to just three in '87. Congress enacted a similar law—but not until four years later.

More recently, state regulators have returned $768 million to investors who had lost money in all-but-worthless limited partnerships peddled by Prudential Securities in the '80s. Federal regulators began an investigation into the Prudential fiasco only after state regulators turned up a nationwide pattern of deceptive practices and investor losses. All told, the states opened 6,379 enforcement cases last year, compared with a mere 497 for the SEC.

State standards for barring bad brokers are also tougher than federal rules, which are set by the National Association of Securities Dealers (NASD), a self-regulatory group. Florida, for instance, refused to grant licenses to 50 questionable brokers and firms last year, even though they met federal standards. "Our philosophy," says Don Saxon, director of the Florida Division of Securities, "is that the best way to protect the investing public is by not allowing problems in the state to begin with."

And finally, state courts have been more willing than the federal bench to broadly define the word security. As a result, state regulators police certain types of oil and gas deals, wireless cable schemes and other exotic investments that the feds aren't allowed to tackle.

▸ **Give less information to investors in new issues.** When you buy stock in an initial public offering, by the time your purchase is confirmed, your broker must send you a final prospectus that spells out a company's operations and the risk of owning its shares. Under the Fields bill, however, brokers would have to deliver the full prospectus only if you ask for it. "My view is that much of what is sent to an investor vis-à-vis a prospectus is not read," says Fields. He also hopes to make prospectuses and other information available on-line.

Although many investors would still get a preliminary prospectus, this document doesn't contain a final stock offering price, and often it would not have been vetted by the SEC for unsupported or exaggerated claims. "If there's no final prospectus that must be delivered, some companies may be much more aggressive in what they say in their preliminary prospectus," says Columbia professor Coffee.

What you can do

Tell us what you think of Rep. Fields' bill (HR 2131) and of the congressional efforts to rewrite U.S. securities laws. We'll relay your thoughts to him and other key lawmakers. Send your letters to:

Washington & Investors
MONEY, Room 32-38
Time & Life Building
Rockefeller Center
New York, N.Y. 10020

Or send e-mail to:
letters@moneymag.com

▸ **Keep investors in the dark about possible corporate takeovers.** To guard against sneak attacks by takeover artists, federal law gives anyone who acquires 5% or more of a company's shares only 10 days from the time of the purchase to inform the SEC and the public. In this instance, Fields thinks that state laws give companies better protection against hostile takeovers. Consequently his bill would scrap the federal disclosure requirement and let each of the 50 states set their own rules governing mergers and acquisitions.

His reform would, among other things, make it more difficult for investors to profit from takeovers. For instance, a raider could secretly accumulate a large block of stock in an undervalued company. But because you know nothing about that, you might sell your shares cheaply and miss out on big gains when the raider bids for the entire company at a premium price. The bill would also allow companies to offer a higher price to the biggest shareholders or to the first investors to sell their shares.

Fields counters by arguing the current strict disclosure law hurts investors because companies waste shareholder funds meeting its requirements. A House Commerce Committee staffer who works for Fields calls the current takeover rule "a fairly hefty tax on friendly mergers." To bolster his point, he suggested that MONEY report just how much the Walt Disney Co. spent complying with the rule when it bid $19 billion for Capital Cities/ABC. We did. The answer is zero. Disney didn't have to make this filing when it bought Cap Cities because the deal was a merger, not a takeover.

Many securities lawyers say that, at most, the disclosure filing adds a minuscule cost to a typical takeover—a flat $100 fee plus lawyers' fees of as much as $5,000. "In my experience, no one has ever said: 'I'm not going to do a large tender offer because there's a filing fee,'" says Dewey Ballantine partner Morton Pierce, a lawyer who represented Disney in the Cap Cities deal.

▸ **Reduce the safeguards that prevent institutional investors, such as municipal money managers, from being sold ill-suited investments.** Lately, after get-

ting stung by massive losses on derivatives, these investors have tried to blame their brokers. For example, Orange County, Calif. has filed a nearly $3 billion lawsuit against Merrill Lynch for selling the county highly risky investments. Under the Fields bill, brokers could no longer be held responsible for "unsuitable" investments sold to pension funds, mutual funds and other institutions that have more than $10 million under management, unless there was a written contract.

As a consequence, the measure would scuttle a proposal by the NASD to require brokers to determine how sophisticated institutional clients are before pitching an investment. "Some institutional investors are looking for what amounts to a guarantee against market loss," Fields explained in a memo to Republican committee members.

He may have a point. However, though the measure is aimed at institutions, it carries hidden risks for average Americans too. For one, it could erode the market for municipal bonds. If a municipal finance manager lost money on unsuitable investments, the investors in his county's muni bonds could face big losses. (And those investment losses might also trigger tax hikes or service cuts for local residents.) "Many 'institutions' are not sophisticated," says former SEC chairman Ruder. "Some of the investments sold to institutions are so complicated that they can be barely understood by the people selling them, much less by the people buying them."

While the Fields legislation is unlikely to pass this year, ripple effects are already being felt. "The bill does not have to pass to have an impact," says former Commerce Committee Republican staffer Stephen Blumenthal. In a taped conference call for institutional investors, he noted that state and federal regulators are "tripping over themselves" to address its underlying concerns. In August, for example, the SEC created a new task force to scrutinize all its corporate regulations and filing requirements. One goal: to cut the regulatory burden on business.

So pay attention. You may even want to drop us a line with your view of the legislation (see the box). "In the 1950s, when the SEC's budget and the states' role were scaled back, you saw an enormous expansion of securities fraud," notes the University of Arizona's Seligman. "It could happen again."

Mr. DINGELL. Mr. Chairman, thank you for recognizing me.

Mr. Cohen, on page 14 of your statement you call for "eliminating the Commission's Enforcement Division as an independent group and turning the enforcement to the control of the various Divisions which create policy at the Commission."

Can you tell me how long it has been that the Enforcement Division has been an independent part of the Commission?

Mr. COHEN. Congressman, I think it's 20 years.

Mr. DINGELL. Twenty years?

Mr. COHEN. I think it would go back to Mr. Sporkin. Maybe Mr. Sommer would remember.

Mr. DINGELL. Why do you suggest that that be done?

Mr. COHEN. Because it's very important that policy be made by the individual division heads who run divisions and are knowledgeable, as opposed to policy being made through enforcement proceedings.

When division heads run things, then you have hearings, you have regulations, you have input. When enforcement runs things, then decisions and laws, at least the precedential law as far as the Commission is concerned, may be set through consent proceeding.

And consent proceedings, consent determinations are not a good way to provide reflection on where the law ought to be at any time.

Mr. DINGELL. You're suggesting that policy is made at the Enforcement Division and not elsewhere in the Commission?

Mr. COHEN. I'm suggesting that the Enforcement Division's role in making policy is much greater than it should be and that in my personal experience, they very much are the tail the wags the dogs of the individual divisions.

Mr. DINGELL. What personal experience convinced you of that?

Mr. COHEN. Personal experience of representing individuals involved in enforcement proceedings with the Commission.

Mr. DINGELL. I see. So you're speaking, then, as a representative of the other side; is that right?

Mr. COHEN. Sometimes I'm on the other side but I think I've done a lot in this industry. I've also been a professor and I've spoken on these issues, tried to look at it from a broad view.

Mr. DINGELL. You're telling me that the agency does not supervise the Enforcement Division?

Mr. COHEN. If you are—Mr. Sommer is here and what I would tell you is that my understanding of commissioners is that they spend an enormous amount of time looking at enforcement proceedings, and that is the single largest element of time that they spend. And by the time——

Mr. DINGELL. And you object to that?

Mr. COHEN. Of course I can't object to it. What I'm saying is that by the time it gets to them, the matter is in front of them, it's generally a consent, and the origin of the matter is not in the division but in the Enforcement Division.

Mr. DINGELL. Are you telling us that there's no consultation and no supervision between the SEC commissioners, the other divisions inside the Commission, and the Enforcement Division?

Mr. COHEN. There's obviously consultation but——

Mr. DINGELL. Pardon?

Mr. COHEN. There obviously is consultation but from my own experience, I've seen that the larger part of the weight comes from enforcement, rather than a particular division.

Mr. DINGELL. Now, the Enforcement Division recommends to the Commission, do they not, and the Commission has to vote on these cases?

Mr. COHEN. Congressman, what happens in the normal proceeding is that a consent is entered between the parties——

Mr. DINGELL. Let's just talk about what happens here. Please be cooperative with me. The way the Enforcement Division functions is they recommend to the Commission an enforcement case. The Commission votes on it and, if the enforcement is approved by the Commission, it then proceeds. Is that not the way it works?

Mr. COHEN. That is the way it proceeds.

Mr. DINGELL. That's the way it works. All right.

Now, Mr. Beese, on page 14 you state that "Large institutional investors have sought to use the suitability rules of the self-regulatory organizations to recover trading losses from their dealer/counter party." How many of these suitability cases are brought each year by institutional investors under NASD and New York Stock Exchange suitability rules?

Mr. BEESE. I don't have that answer with me, Congressman. I'd be happy to submit it to you.

Mr. DINGELL. You don't know?

Mr. BEESE. I don't have the number.

Mr. DINGELL. Do you know whether any are brought?

Mr. BEESE. It's my understanding that they are.

Mr. DINGELL. Would you be astonished if I told you that there were none?

Mr. BEESE. I don't suppose so.

Mr. DINGELL. Pardon?

Mr. BEESE. I'm not astonished.

Mr. DINGELL. Well, supposing I told you none. What would you say?

Mr. BEESE. I'd want to consult with my staff and ask them about their research.

Mr. DINGELL. You'd obviously be embarrassed because in your statement you'd misinformed the committee; isn't that right?

Mr. BEESE. That is correct.

Mr. DINGELL. Now, let's talk about West Virginia and Orange County. Would you cite them as being cases where this had occurred?

Mr. BEESE. I'd cite them as examples of large institutional investors where that is an open issue.

Mr. DINGELL. Well, let's talk about West Virginia. West Virginia brought its case under State law alleging fraud. Orange County's Federal and State law claims allege fraud but not violation of New York Stock Exchange or NASD rules.

Do these events embarrass you?

Mr. BEESE. No. As I said in my opening statement, I am very strong in enforcement and always have been very strong in enforcement. And I believe that we have to take a look at the suitability rules. Any type of fraud on the part of any broker-dealer should be severely punished.

Mr. DINGELL. But the fact of the matter is, however——

Mr. BEESE. But brokers can't guarantee——

Mr. DINGELL. [continuing] the suitability rules have never—you cannot cite a single case in which the suitability rules have been used in this way. As a matter of fact, I have pointed out that in no instance has this occurred.

[The response follows:]

CENTER FOR STRATEGIC & INTERNATIONAL STUDIES,
WASHINGTON, DC,
December 5, 1995.

The Honorable JOHN D. DINGELL
Ranking Member,
Committee on Commerce,
United States House of Representatives,
2322 Rayburn House Office Building'
Washington, DC 20515.

DEAR REPRESENTATIVE DINGELL: It was a privilege to testify before you and the other members of the Subcommittee on Telecommunications and Finance on November 14th regarding H.R. 2131, the "Capital Markets Deregulation and Liberalization Act of 1995." As I indicated in my testimony, I believe that the Subcommittee's effort to review the nation's securities laws is timely given the significant changes that have taken place in the capital markets.

During the course of the hearing, you raised a question regarding the accuracy of one sentence in my written testimony concerning suitability. In particular, you suggested that the following statement was incorrect and potentially misleading:

> "Large institutional investors have sought to use the suitability rules of the self-regulatory organizations to recover trading losses from their dealer/counterparty." [1]

You objected to the statement on the grounds that the suitability rules have not ever been used to recover such losses. While expressing my sincere intention never to mislead the Committee, I suggested that I would be best able to respond to your concerns in writing following the hearing.

Having reviewed the issue, I remain convinced that my statement is factually correct. The New York Stock Exchange, American Stock Exchange and the National Association of Securities Dealers require that when a broker dealer recommends a transaction to a customer, the broker shall have "reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by the customer... as to his financial situation and needs.[2] Even when a broker does not make a recommendation, the suitability doctrine imposed on a broker "a responsibility to determine, on the basis of information which he has or should have, that the risk aspects of the contemplated investment are within the risk threshold of the customer who is purchasing the security." [3]

To the best of my knowledge, you are correct in your assertion that the SRO-based suitability doctrine has not been the basis for successful recovery at the circuit or Supreme Court level to date. Whether this standard has been raised to the level of a principal of law depends on whether the obligation to make suitable recommendations is a duty which has been incorporated by the antifraud provisions of the securities laws.[4]

However as my testimony states, several cases are pending before the courts which seek to use the standards established by the SRO rules to measure a broker-dealer's duty of care to its customer. Most notably, a significant portion of the Orange County case[5] is premised, in part, on the SRO suitability rules. In paragraph 30, the Complaint states that the defendant dealer/counterparty encouraged transactions that were "unsuitable." In paragraph 45, the Complaint contends that the defendant "was obligated by law and by the *regulations governing the conduct of broker-dealers* to be familiar with the County's financial status, budget, and invest-

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[1] Testimony of J. Carter Beese before the Subcommittee on Telecommunications and Finance, U.S. House of Representatives, November 14, 1995.

[2] *See* NASD Rules of Fair Practice, CCH NASD Manual, Art. III, Sec. 2, Par. 2152. *See also* NYSE Rule 405, 2 NYSE Guide (CCH) Par. 2405.

[3] *See* Robert Mundheim, *Professional Responsibilities of Broker-Dealers: The suitability Doctrine.* Duke L.J. 445, 449 (1965).

[4] *See* Roberta Karmel, "The Suitability Doctrine," *New York Law Journal* 5 (June, 15, 1995).

[5] *In re Orange County Investment Pools*, complaint of Orange County Investment Pools, Plaintiff, v. Merrill Lynch & Co., Inc. (Bankr. C.D. Cal.) (No. SA 94222-72) (Jan. 12, 1995.)

ment objectives" (emphasis added). Further, in paragraph 60, the Complaint asserts that the defendant "owed a fiduciary duty to the County to exercise due care in rendering financial advice to the County and is *governed by regulations governing the conduct of broker dealers, including those promulgated by the New York Stock Exchange, American Stock Exchange, and the National Association of Securities Dealers* (emphasis added). As a consequence of such alleged misconduct, the Complaint requests damages "in excess of $2 billion." [6]

As importantly, I do not believe that my statement was misleading in light of the legislative intent of H.R. 2131. I would note that the Commerce Committee's news release concerning the bill makes virtually the same reference as in my testimony. The release, dated July 27, 1995, states, "Suitability—Large institutional investors have occasionally sought to exploit the *rules on suitability* to shift losses on securities to broker/dealers, seeking what amounts to a guarantee against market losses." (emphasis added). While this statement does not specifically reference the SRO's, the rules to which it refers are clearly one and the same.

I hope that the comments herein respond to your concerns and remain happy to assist you and the Subcommittee in any way that I can as the legislation continues to evolve.

Respectfully submitted,

J. CARTER BEESE, JR.,
Senior Adviser

Mr. DINGELL. Mr. Chairman, I have some other questions and perhaps on the second round I could be recognized.

Mr. FIELDS. The Chair thanks the gentleman. The gentleman from Pennsylvania, Mr. Klink.

Mr. KLINK. Thank you very much, Mr. Chairman.

Professor Coffee, I have a list here which I've been looking over this morning. It's a list of charities and institutions that—it's a very interesting one—were victimized by the massive New Era fraud that was revealed earlier this year. I won't go over the list in all. It's 12 pages.

I would ask unanimous consent, Mr. Chairman, if this list could be made part of the hearing record.

Mr. FIELDS. Excuse me. I did not hear the gentleman. What was the question?

Mr. KLINK. I ask unanimous consent that the list of charities and institutions that were victimized by the New Era Philanthropy fraud earlier this year, that this list might be made part of the hearing record.

Mr. FIELDS. Without objection.

[The information referred to follows:]

[6] *Id.* at Par. 62.

Victims of New Era's scheme

Here is a list of charities and institutions with money promised to them by the Foundation for New Era Philanthropy, according to papers released by U.S. Bankruptcy Court. The court did not specify how much money was owed to individual charities. Asterisk denotes Pennsylvania institutions and individuals.

Institutions

*Access Inc.; Conshohocken, Pa.

*Agnes Irwin School; Rosemont, Pa.

America's Keswick; Whiting, N.J.

*American Music Theater Fest., Phila.

*American Red Cross Blood Services, Penn-Jersey Region; Phila.

*American Red Cross, Phila.

*Baker Industries, Inc.; Paoli, Pa.

*Balch Institute for Ethnic Studies; Phila.

*Baptist Bible College; Clarks Summit, Pa.

Baptists for Life, Inc.; Grand Rapids, Mich.

*Beaver College; Glenside, Pa.

BEE International; Dallas.

*Bethanna; Southampton, Pa.

*Biblical Theological Sem.; Hatfield, Pa.

Biola University; La Mirada, Calif.

Boston College; Chestnut Hill, Mass.

Bowery Mission; Chappaqua, N.Y.

Business & Professional Outreach; New York.

Calif. Institute of Integral Studies; San Francisco.

CB International; Wheaton, Ill.

Center for Theology and the Natural Sciences; Berkeley, Calif.

Central College; McPherson, Kan.

Christian Business Men's Committee; Chattanooga, Tenn.

Christian Camps & Conferences; Alton, N.H.

Christian College Coalition; Washington, D.C.

*Christian Counseling & Education Foundation; Laverock, Pa.

*Christian Schoool of York; York, Pa.

Cities in Schools, Inc.; Alexandria, Va.

Citivision; Grand Rapids, Mich.

Classroom Inc.; New York.

Compassion International; Colo. Springs, Colo.

Concerts of Prayer; Wheaton, Ill.

Covenant College; Lookout Mountain, Ga.

*Creative Artists Network; Phila.

*CUTS; Phila.

Daystar University College; Edina, Minn.

*Delaware County Christian School; Newtown Square, Pa.

Detroit Institute of Arts; Detroit.

*Drexel University; Phila.

*Eastern Baptist Theol. Sem.; Wynnewood, Pa.

*Eastern College; St. Davids, Pa.

English Language Institute; San Dimas, Calif.

*Ephrata Community Hospital Foundation; Ephrata, Pa.

*Esperanza Health Center; Phila.

*Evangelical Ministries Inc.; Phila.

F.O.C.U.S.; Vineyard Haven, Mass.

Focus on the Family; Colo. Springs, Colo.

Freedom Baptist Schools; Hudsonville, Mich.

*Friendship Ministries; Devon, Pa.

Frontiers; Mesa, Ariz.

Fuller Theol. Sem.; Pasadena, Calif.

Gordon College; Wenham, Mass.

Gordon-Conwell Theol. Sem.; South Hamilton, Mass.

Gospel Volunteers Inc.; Speculator, N.Y.

Gull Lake Bible Conference; Hickory Corners, Mich.

Haggai Institute; Atlanta, Ga.

Harvey Cedars Bible Conference; Harvey Cedars, N.J.

*Hispanic Century Fund; Phila.

Honey Run Camp; Three Lakes, Wis.

Hospital Chaplains' Ministry of America; Huntington Beach, Calif.

Houghton College; Houghton, N.Y.

Inter-Varsity Christian Fellowship; Madison, Wis.

Interdev; Seattle, Wash.

*International Missions; Reading, Pa.

International Teams; Prospect Heights, Ill.

Jim Elliot Schools; Denver, Colo.

John Brown University; Siloam Springs, Ark.

Juvenile Diabetes Foundation; New York

King College; Bristol, Tenn.

Lake Geneva Youth Camp and Conference Center; Lake Geneva, Wis.

*Lancaster Bible College; Lancaster, Pa.

*Lancaster Christian School; Lancaster, Pa.

*Landis Homes Retirement Community; Lititz, Pa.

Life Ministries; San Dimas, Calif.

*Lititz Christian School; Lititz, Pa.

Luis Palau Evangelistic Assoc.; Portland, Ore.

MAP International; Brunswick, Ga.

Maranatha Bible & Missionary Conf.; Muskegon, Mich.

Market Street Mission; Morristown, N.J.

Mayerson Academy for Human Resource Development; Cincinnati.

*Meadowbrook Christian School; Milton, Pa.

*Menno Haven, Inc.; Chambersburg, Pa.

Mercy Corps. International; Redmond, Wash.

Mercy Medical Airlift; Manassas, Va.

Mercy Ships; Lindale, Texas.

*Messiah College; Grantham, Pa.

Middle East Media; Lynnwood, Wash.

Mission Aviation Fellowship; Redlands, Calif.

Mission India; Grand Rapids, Mich.

Mission to the Americas; Wheaton, Ill.

Moody Bible Institute; Chicago, Ill.

National Coalition Against Pornography; Cincinnati.

National Foundation for Teaching Entrepreneurship; New York.

*National Museum of American Jewish History; Phila.

New Hope Counseling Center; Forest Hills, N.Y.

Operation Mobilization; Tyrone, Ga.

Opportunity International; Oak Brook, Ill.

Overseas Council; Greenwood, Ind.

P.R.O. Missions; Cordova, Tenn.

*Penn Christian Academy; Norristown, Pa.

*Pennsylvania Acad. of Fine Arts; Phila.

*Phila. College of Bible; Langhorne, Pa.

*Phila. Tennis Patrons Association; Devon, Pa.

Pioneers; Orlando, Fla.

*Plumstead Christian School; Plumsteadville, Pa.

*Presbyterian Children's Village; Rosemont, Pa.

Prison Fellowship Ministries; Washington, D.C.

Ravi Zacharias International Ministries; Norcross, Ga.

*RBMU/WorldTeam; Warrington, Pa.

*Reaching Urban Neighborhoods; Sellersville, Pa.

Rescue Mission; Syracuse, N.Y.

S.I.M.; Charlotte, N.C.

*Salvation Army; Phila.

*Scripture Union; Upper Darby, Pa.

*Seminary of the East; Ft. Washington, Pa.

SEND International; Framington, Mich.

*Settlement Music School; Phila.

South Shore Christian Academy; East Weymouth, Mass.

Southfield Christian School; Southfield, Mich.

Spence-Chapin Services to Families and Children; New York.

Spring Arbor College; Spring Arbor, Mich.

STARS; Chattanooga, Tenn.

TEAM (The Evangelical Alliance Mission); Carol Stream, Ill.

*The Christian Academy; Media, Pa.

*The Franklin Institute; Phila.

*The Free Library of Phila.; Phila.

The Jesus Film Project; San Clemente, Calif.

The King's Christian School; Haddon Heights, N.J.

*The Living Word Academy; Lancaster, Pa.

The Mendenhall Ministries; Mendenhall, Miss.

The Nature Conservancy; Arlington, Va.

*The Phila. Orchestra Association; Phila.

*Transport for Christ; Denver, Pa.

United Theological Seminary; Dayton, Ohio.

*United Way of Southeastern Pennsylvania; Phila.

United World Mission; Union Mills, N.C.

*University of Pennsylvania Cancer Center; Phila.

*University of Pennsylvania; Phila.

*Valley Forge Specialized Educational Services Corporation; Paoli, Pa.

Vision Foundation; Knoxville, Tenn.

Walk Thru The Bible Ministries; Fort Mills, S.C.

*Water Street Rescue Mission; Lancaster, Pa.

*Westminster Theological Seminary; Glenside, Pa.

Wheaton Christian High School; West Chicago, Ill.

Wheaton College; Wheaton, Ill.

*White-Williams Scholars; Phila.

Whitworth College; Spokane, Wash.

*WHYY; Phila.

Wilmington Christian School; Hockessin, Del.

World Christian, Inc.; Ventura, Calif.

World Concern; Seattle.

*World Harvest Mission; Oreland, Pa.

World Impact; Los Angeles.

World Radio Missionary Fellowship, Inc.; Colorado Springs, Colo.

World Vision, Inc.; Monrovia, Calif.

Worldwide Leadership Council Inc.; Englewood, Colo.

Young Life International Service Center; Colorado Springs, Colo.

Youth For Christ; Dix Hills, N.Y.

Youth Investment Foundation; Minnetonka, Minn.

Business Related

Dave Chapple (artist); Irvine, Calif.

Jim Cummings; Pennsauken, N.J.

Boston Coach; Everett, Mass.

*Bell Atlantic; Lehigh Valley, Pa.

*ATX; Bala Cynwyd, Pa.

*Filterfresh; Conshohocken, Pa.

*The Fasig Corp; Allentown, Pa.

*Frank Feldler; Broomall, Pa.

Os Guiness; Burke, Va.

*C.B. Kershner's; Phila., Pa.

*Kelly's Trophies; Drexel Hill, Pa.

*Robert Johnstone; Perkasie, Pa.

*Lizell's Office Furniture; Montomeryville, Pa.

*MCM Consultants; Blue Bell, Pa.

*Merchants Manufacturers & Profession

Multiple Employer Trust; King of Prussia, Pa.

Leadership Development; Washington, D.C.

Minolta Leasing Services; Atlanta.

*Main Line Travel Ser.; Bala Cynwyd, Pa.

*David B. Morgan III. Glenmoore, Pa.

Prospect Pictures; London.

*Radnor Hotel; St. Davids, Pa.

*Beverly Rehfeld; Phila.

*Smith Fox Associates, Inc; Telford, Pa.

*Radnor Center Associates; Phila.

*Stradley, Ronon, Stevens & Young; Phila.

United Parcel Service; Louisville, Ky.

*West Catholic High School; Phila.

*Yoder & Armstrong; E. Lansdowne, Pa.

*Your Gourmet Kitchen; Wayne, Pa.

Individuals

*Academy of Natural Sciences, Honor Fox; Phila.

*Charles L. Andes; Haverford, Pa.

*Philip J. Baur Jr.; Ambler, Pa.

*Leif C. Beck; Villanova, Pa.

*R. Theodore Benna; New Hope, Pa.

George F. Bennett; Boston, Mass.

George F. Bennett Jr; Boston, Mass.

Peter C. Bennett; Hingham, Mass.

*Peter Benoliel; St. Davids, Pa.

Lewis Bernard; New York.

Michael D. Bills; Charlottesville, Va.

*Glenn Blossom; Dresher, Pa.

Geoffrey Boisi; New York.

Pat Boone; Los Angeles.

William K. Brehm, chairman, SRA Intl., Inc.; Arlington, Va.

Robert Brown; High Point, N.C.

*J. Mahlon Buck Jr., president, TDH Capital Corp.; Radnor, Pa.

*William Buck; Villanova, Pa.

Robert Buford; Dallas.

David Bussau, Maranatha Trust; Australia.

Howard Butt; Kerrville, Texas.

*Robert Byers, Byers Foundation; Chalfont, Pa.

Carlos H. Cantu; president & CEO, Service Master; Downers Grove, Ill.

Raymond G. Chambers; Morristown, N.J.

Jeffrey W. Comment; president & CEO, Felsberg Diamonds; N. Kansas City, Mo.

Cornerstone Trust, Ron Williams; Grand Rapids, Mich.

*Larry E. Creasy; Coatesville, Pa.

Lynn Day; Grosse Point, Mich.

James DeKruyter; Kalamazoo, Mich.

Max DePree; Holland, Mich.

Patrick Duff; Glen Rock, N.J.

John A. Duke; Rogue River, Ore.

Tom Dykstra; Wyoming, Mich.

*Timothy B. Eckel; Anville, Pa.

*Eric Eichler; Malvern, Pa.

Merle L. Embleton, Greenwood, Del.

*Michael Erikson; Phila.

R.D. Erikson; Hinsdale, Ill.

Eugene V. Fife, Goldman Sachs; London.

*Charles Frey; Lancaster, Pa.

Charles D. Fulton; Cherry Hill, N.J.

John Griffin, New York.

* John Haas, Rohm & Haas Bldg.; Phila.

*The Huston Federation, Nancy Hansen, vice president; West Conshohocken, Pa.

*The Stewart Huston Charitable Trust, Louis J. Beccaria; Coatsville, Pa.

*Henry Harris; Wyndmoor, Pa.

*Nelson Harris; Lafayette Hill, Pa.

*Marvin D. Heaps; Swarthmore, Pa.

*John Hebden; Jenkintown, Pa.

*James S. Herr; Nottingham, Pa.

*Erik T. Hostvedt; Coopersville, Pa.

Clarence Huisenga; Holland, Mich.

Robert Hunsberger; Bridgeville, Del.

Sanford Jett; Lisle, Ill.

Paul Johnson, Johnson Foundation; Birmingham, Miss.

William Kanaga; Orleans, Mass.

Christine King; Larchmont, N.Y.

Stephen B. Klinsky; New York.

Wim Kooyker, Blenheim Investment Inc.; Somerset, N.J.

*Ronald D. Kuykendall, president, East Co.; Wayne, Pa.

*Claire Lesman; Coatesville, Pa.

Rev. Phillip S.L. Lee; Mountain View, Calif.

Raymond C. Lee; South Hamilton, Mass.

*Henry Longacre; Franconia, Pa.

*Horace W. Longacre; Souderton, Pa.

*Thatcher Longstreth; Phila.

David Mace; New York.

*Jane C. MacElree; Newtown Square, Pa.

Hugh Maclellan, The Maclellan Foundation; Chattanooga, Tenn.

*Andrew Maier II; Reading, Pa.

Stephen Frank Mandel Jr; Darien, Conn.

Beatrice G. Mersig; Oneonta, N.Y.

The Milkon Christian Foundation, Patricia A. Cannon, director; Columbia, SC

Joanna Mockler; Wayland, Mass.

Don Modglin, Modglin Family Foundation; Huntington Beach; Calif.

*Warren V. Musser, chairman & CEO, Safeguard Sciences, Inc.; Wayne, Pa.

Doug Nagel; Stuart, Fla.

*Joseph Neubauer; Phila.

One to One, Karen Finnigan; Washington, D.C.

*Jane J. O'Neil; Phila.

David Parks; Plymouth, Mass.

John C. Pepper, Procter & Gamble Co.; Cincinnati.

Thomas Phillips, director, Raytheon Co.; Lexington, Mass.

*Vivian Piasecki; Haverford, Pa.

C. William Pollard; Wheaton, Ill.

*Alex Rankin; Bedminster, Pa.

Samuel T. Reeves, president, Dunavent Enterprioses, Inc.; Fresno, Calif.

William Reichardt; River Forest, Ill.

Frank E. Richardson, president, Wesray Capital Corp., New York.

Julian Robertson, president, Tiger Management Corp.; New York.

Laurence Rockefeller, The Rockefeller Center; New York.

Mary French Rockefeller, New York.

*George M. Ross, The Family Foundation; Phila.

*H.F. Schackleton; Maple Glen, Pa.

William Simon; Morristown, N.J.

Wesley Skinner; Kirkville, N.Y.

*Richard L. Smoot; Radnor, Pa.

Don Soderquist; Rogers, Ark.

*C. Davis Weyerhaeuser; Phila.

Paul F. Tell; Boca Raton, Fla.

*John M. Templeton Jr; Bryn Mawr, Pa.

John O. Van Der Aa, Oakbrook Ter., Ill.

James Vander Mey; Ocala, Fla.

Ron VanderPol; Grand Rapids, Mich.

Robert Van Kampen, End Haven, Mich.

Ernest Volgenau, president, SRA International Inc.; Arlington, Va.

Kurt Weishaupt; New York.

Richard A. West; Westwood Endowment; Indianapolis.

Glenn E. White; Bloomfield Hills, Mich.

John C. Whitehead; Whitehead Foundation, New York.

*A. Morris Williams Jr.; Miller, Anderson & Shererd; West Conshohocken, Pa.

John H.T. Wilson, Morgan Stanley & Co. Inc; New York.

*Richard A. Wilson, Lancaster Bible College; Lancaster, Pa.

See related story "Colleges will give profit back," by AP which appeared on page A19, THIRD EDITION.

LOAD-DATE-MDC: May 30, 1995

Mr. KLINK. Thank you.

The list is very extraordinary, quite frankly. It has names like the American Red Cross, the Biblical Theology Seminary, Landis Homes Retirement Community, Kings Christian School, the National Coalition Against Pornography, the Salvation Army, the University of Pennsylvania Cancer Center, the Philadelphia Orchestra Association. Those are just a few of hundreds of institutions that are listed.

Professor Coffee, these are examples of some of the institutions that will have to fend for themselves in dealing with Wall Street if we eliminate the suitability requirement. Given this type of venomous ethic that's prominently been reported at some—not all but some Wall Street firms, including at least one thought to be among the most prestigious, are any of these institutional investors likely to really stand a chance in fending for themselves?

Mr. COFFEE. I think, Congressman, that I agree with you that institutional investors can be defrauded and that some institutional investors are unsophisticated, and it's always a factual question.

What I would add that is probably a clarifying comment is that I am not sure that under existing law today, under existing Rule 10B(5), any broker-dealer firm is actually legally "responsible" for the investment decisions of an institutional client. All that suitability doctrine requires is that information known to the broker-dealer about the unsuitability of a security be conveyed to the institutional client.

So it's a relatively modest obligation. What I'm trying to suggest is that I don't believe that suitability doctrine does provide some insurance right to the institutional investor. What I think is the institutional investor's real right is to full disclosure of material omissions; that is, where there is material information known to the broker-dealer firm and where the relationship between the broker-dealer and the client is a fiduciary one, one of trust and confidence, then I believe that the law today says and should say that there is an obligation on the broker-dealer to disclose material information known to it and not known to the client.

And I hope that that is not confused by anything done with respect to the claim that suitability rules makes the broker-dealer responsible for the institution's decision.

Mr. KLINK. Let me back up for a second. One of the things that we're concerned about, and judging by some of the comments that those of you who are testifying before us made, as well as the opening statements by some of my colleagues, I mean what we seem to be concerned about is not only protecting the investors, making them feel like we're there for them, but that also enhances the capital formation process. That's what this is about.

So I think that the underlying current of my question is does the change in the suitability rule have an unintended consequence of causing some of these institutional investors to leave the marketplace, thereby not bringing their dollars into capital formation? Mr. Coffee, I'll let you follow up.

Mr. COFFEE. That is a possibility. I can't predict one way or the other. There are some institutions that need greatly changed internal governance, and we have seen those cases this year in making decisions.

I really can't predict whether institutions will leave the market, but I do think investor confidence is a prerequisite to capital formation.

Mr. KLINK. I don't want to put words in your mouth but from your answer what I've gotten is that this proposal to repeal suitability for institutions could really undermine the anti-fraud protections that we now have in place.

Mr. COFFEE. There is an opaque quality to the legislative provision that I see. Whether or not it would be read by a court as a possible partial implied repeal of the obligation under Rule 10B–5 to disclose material information in your possession to your client is an area that I'm uncertain how a court would read this provision.

I know that I believe that the NASD is on the right track when they have tried to focus the inquiry not on the financial assets of the institution but on the institution's actual sophistication.

Mr. KLINK. As my colleague just said to me, what is the appropriateness of it if it's opaque? I mean, I don't understand why we're headed that direction.

Mr. COFFEE. I think I am agreeing with you that the NASD is on the right track with its new suitability rule. And if this provision were read to deny them authority to adopt that form of new, revised suitability rule, I think it would be unfortunate.

Mr. KLINK. Mr. Chairman, I yield back my time and look forward to the next round of questions.

Mr. FIELDS. The gentleman's time has expired. The gentleman from California, Mr. Cox.

Mr. CHRISTOPHER COX. Thank you, Mr. Chairman.

I'd like to talk with the panel about merit review because I'm not certain that even the Congress has the political muscle to achieve reform in this area. The SEC has to work on a regular basis with NASAA. Broker-dealers, underwriters, and investment bankers have to work with the State regulators. And as we have alluded to this morning, there's a lot of money involved to the States.

How can we overcome the barriers to reform in this area that exist politically and financially in terms of State finances, if there's so much right now preventing us from doing so? I'll address it to the panel but Mr. Cohen, you seem prepared to answer.

Mr. COHEN. My written statement called for a renewed role for the States that focussed on fraud enforcement. In the same way that I talked about moving the Enforcement Division, it wasn't to get rid of the enforcement effect of the SEC; it was just to move it into a better policymaking area, where it could be controlled better and be more efficient.

With regard to the States, what one would hope would happen and what this bill seeks to do is to move up their standards. The State standards of due process are woefully low. This bill, if enacted, would cause the States to follow uniform Federal laws. That would be very important. It would give them a very important role.

If one assigned to them, for example, the ability to review the actions of investment advisers of small size, they would then have a revenue device that would be worthwhile to them. But they play no meaningful role at this point in the process of raising money for the public. They're just an impediment. And the concept that some

State commissioner will have a better sense of value than the market, I don't think is borne out by any kind of economics, as we know it in the 1990's.

Mr. CHRISTOPHER COX. I wonder if I could address that question also to the panel. I see that Dr. Cox is interested in responding to the previous question.

Mr. CHARLES COX. I just wanted to add the comment that often the discussion on this topic proceeds by anecdotes of pointing out that here's a case where some meritless securities were not sold and the company later failed, so investors were protected. But for every anecdote like that, there's one on the other side where a security was not allowed to be marketed and the company turned out to be a stunning success.

My interpretation of these things is that State regulators have no more insight into securities that possess merit or don't possess merit than investors who have the benefit of full disclosure under the SEC's rules and the Federal securities laws.

So for this reason, I paid close attention to merit regulation as used in other countries while I was a member of the Commission and time and again I came to the conclusion that the full disclosure approach is overwhelmingly better because regulators don't have the insight to evaluate better than investors who are placing their money where their mouths are.

Mr. CHRISTOPHER COX. For this purpose I hope that we can all agree that by merit review we mean particularly review focussed on the price. There are other things that might make an offering meritorious or not, some of them really disclosure-oriented, and I don't want to be confused, in a layperson sense, on that point.

Is there anybody on the panel who believes that in not an intrastate offering but in a national offering that State regulators should be in the position of second-guessing the decision as to the price at which common stock should be offered to the public?

Mr. SOMMER. Mr. Cox, they're not in that position now. Any offering by a company that is a listed company on an exchange or listed in the NASDAQ NMS or which, after the offering, is going to be listed on an exchange or on the NASDAQ NMS is not subject to any regulation as to merit with regard to the States or even review of their disclosure.

So with regard to an overwhelming number of public offerings that are made, there is no merit review and there's no necessity of any filing with the State regulators, other than perhaps a notice filing, but they have essentially abandoned jurisdiction with regard to those offerings.

Mr. FIELDS. The gentleman's time has expired. There will be a second round of questioning.

Mr. CHRISTOPHER COX. I appreciate it. We need to pick this up, I think.

Mr. FIELDS. The Chair now recognizes the gentlelady from California, Ms. Eshoo.

Ms. ESHOO. Thank you, Mr. Chairman.

My question is directed to Professor Coffee. Could you clarify for me what companies are and what companies are not required to register their securities in the States? And is it true that all companies listed on the New York Stock Exchange, American Stock Ex-

change, NASDAQ, are entirely exempt from any State registration requirements?

Mr. COFFEE. I can't tell you the law for every single 52 jurisdictions but the very strongly prevailing rule is that exchange-listed or NASDAQ national market securities qualify simply by a process known as qualification, which is nothing more than a notice filing.

So I don't believe today there is any burden on the exchange-listed or NASDAQ national market system company——

Ms. ESHOO. So you're saying the overwhelming number of States are exempt from any State registration requirements?

Mr. COFFEE. The vast majority of States, that it true. The area where we're really dealing with this issue is in the large IPO, the large initial public offering.

Ms. ESHOO. Now, do you have a ballpark idea of how many publicly owned companies we're talking about that enjoy the exemption?

Mr. COFFEE. If you take the total listing on the New York Stock Exchange, the AMEX and the national market system, I think that you're probably dealing with something in the neighborhood of—this is very loose, round numbers—neighborhood of maybe 8,000 companies that, adding up New York, American, NASDAQ, national market, it might be that level of companies that would thereby be exempt.

Ms. ESHOO. Do any other companies enjoy exemptions from State registration?

Mr. COFFEE. Well again, there are other exemptions under the blue sky rules, depending on State by State, but all I can say broadly is under the uniform blue sky statute that most States have, this kind of exchange listing would broadly exempt them from any kind of intrusive regulation.

Ms. ESHOO. I see. What's the profile of the companies that are required to register?

Mr. COFFEE. The burden is going to fall most heavily on the initial public offering, and that could be either a national initial public offering of the kind some are talking about or a more regional public offering. I realize that the current bill would exclude the blank check company at the very bottom of this profile from the companies that would get immunity, but there are a lot of companies just over that line, and those——

Ms. ESHOO. Are they companies that are much smaller and because they're smaller, that investors would not be as likely to have learned or know much about them through the media?

Mr. COFFEE. I think it is fair to say, in the case of the small, thinly held company, there are thousands of companies which are——

Ms. ESHOO. I'm learning more new terminology. Thinly—what was that? Thinly held?

Mr. COFFEE. A company that is not traded in what I'll call an——

Ms. ESHOO. Thinly held and opaque. It all sounds like stockings.

Mr. COFFEE. That is a new perception.

Ms. ESHOO. Well, women are here now, so we have sometimes a little different take on it.

Mr. COFFEE. But what I was trying to agree with you, Congressman, is that there are several thousand companies out there that are probably not followed by a single securities analyst, meaning that there isn't the professional expertise of the investment community following that stock on a current basis. And that is the kind of stock where I think information does not disseminate well and does not get incorporated into price.

Ms. ESHOO. Which is an area that we really need to be mindful of here, I think, because we need to not only be talking about this in chunks and blocks but differentiate what is exempted and those that are not, what the profile is, and then how the investor connects with that.

What securities do go through State merit review? Are they penny stocks? Is it real estate or oil and gas limited partnerships? What are they? I mean, we've already established the overwhelming number that aren't and it's the vast majority of States.

Mr. COFFEE. Remember merit review is something that the majority of States do not engage in. I think we're down to the neighborhood of a dozen or so States that still review the actual merits of the stock under a provision that looks to whether the offering is considered to be fair and equitable for that particular jurisdiction.

Generally that review tends to focus on transactions between the promoters and the company in recent years. Is there cheap stock? Did the underwriters get, in addition to their underwriters' discount, some large amount of warrants that will entitle them to buy the stock cheap over the next 4 or 5 years?

Those kind of self-dealing transactions have been the primary focus of merit review over the years.

Ms. ESHOO. Aren't these the type of companies that are most likely to have problems, what you just described?

Mr. COFFEE. Well, small companies are, of course, riskier than large companies. I'm not saying that risky companies are necessarily fraudulent companies but small companies would be more typically higher risk companies.

Ms. ESHOO. I see that the light has come on or did it just go back to green? You're giving me some more time, Mr. Chairman?

Mr. FIELDS. I'm being quick.

Ms. ESHOO. We'll come back around. Thank you.

Mr. FIELDS. The gentlelady's time has expired.

The Chair will recognize himself for 5 minutes.

Let me ask the three people who have served on the Commission what I think is the central question on preemption. Rather than duplicating existing Federal laws, wouldn't it be more efficient and effective for States to concentrate their resources on the prevention and punishment of securities fraud, rather than on the duplication of Federal laws?

Now, I realize that's been asked in several forms but to get a clear answer, Mr. Cox, first from you.

Mr. CHARLES COX. I agree with that completely. I think that you have to start by looking at the market for these kinds of securities. We're even past talking about a national market anymore. We're talking about an international market, for all effects.

But as far as what regulation can cover, we're looking at a national market. And in doing that, I think that the scope of regulation that would be most efficient is at the national level. Therefore, as far as registration requirements, I think that it makes most sense to place that at the national regulatory level.

As far as enforcement of anti-fraud provisions and investigating for fraud, that can be done at the State level, as well as the national level.

Mr. FIELDS. Mr. Beese, let me ask you.

Mr. BEESE. I would strongly concur. A system of uniform disclosure laws, very good, in-depth disclosure, and then a strong enforcement system. The SEC enforcement system will always be constrained, no matter what its budget, by finite resources.

I, for one, would like to see the SEC enforcement even have more money than it does today, but it'll never be enough to cover the entire country. It should be augmented by a very strong State enforcement. That is a real role for the States to play on an on-going basis.

Mr. FIELDS. Mr. Sommer?

Mr. SOMMER. Mr. Chairman, I think generally I agree with what's been said. I think it should be borne in mind that there is presently a great deal of collaboration between the State authorities and the SEC and the self-regulators in enforcing the Federal laws and the SRO regulations and all that.

I think it is well that the States focus their attention upon those areas that are of particular concern to them and not spend them on the kind of issues that are exempt under their laws anyway. As has been mentioned here repeatedly, a large number of the public offerings that are made today are exempt from any interference or anything of the States except the necessity perhaps of routine filing.

I think it is well that they focus their resources upon those areas that are particularly of concern, which are the smaller offerings where the companies are not known, where they're highly speculative, where there have been abuses between the corporation and the insiders in the way of transactions, where there's excessive compensation to those who are selling the securities. Those are areas that I think the States should properly pay heed to.

And I think that in large measure, the process is now working very simply. I don't preclude the possibility of legislation that would make the lines clearer and sharper but I think by and large, there has been a concentration in recent years of State resources in the areas where they're most needed.

Mr. FIELDS. Mr. Cohen and Professor Coffee, do you disagree or do you have anything further on this particular question?

Mr. COFFEE. I actually think I can pass on this point. I think I've expressed my view.

Mr. COHEN. So have I.

Mr. FIELDS. Mr. Sommer, you mentioned collaboration, again to our three former commissioners and our acting chairman. In telecommunications we have a concept that we developed within this subcommittee relative to universal service. We envision a joint Federal-state board looking at a very complex subject and coming up

with recommendations on actually how universal service will be applied in the future.

Would there be any merit to some type of joint Federal-state effort but perhaps more of a focussed effort?

Mr. SOMMER. Mr. Chairman, I think that would be an excellent idea. I think that there's an effort going on by NASA administrators, the State administrators, to review this whole area. I think it would be well if it were a collaborative effort involving the Federal regulators and State regulators. I think there's considerable sense in that.

There is an on-going relationship that perhaps should be strengthened between the State regulators and the SEC. Perhaps it should be formalized in a new fashion but there certainly is nothing wrong with anything that would move in that direction.

Mr. FIELDS. Mr. Beese?

Mr. BEESE. Yes, Mr. Chairman. Clearly the redundancy should be eliminated. There is too much overlapping between Federal and State. Let's streamline that and let's take those savings and put it into greater enforcement that penalizes the bad faith actors but reduces some of the cost and burden on those that are good faith players in the marketplace.

Mr. FIELDS. Very quickly, the concept of a joint Federal-state board, perhaps more formalized, that would be a collaborative effort, not at this particular moment but into the future.

Mr. BEESE. I think the concept has great merit if it could be determined that you could have some sort of uniformity among the personalities among the States.

Mr. FIELDS. Mr. Cox very quickly.

Mr. CHARLES COX. I agree that presently there are efforts that go on. There are organizations, NASAA, that purport to speak for the States. But any time you get into a joint effort such as you're suggesting, there is a real question of will you have a body that speaks for all of the State jurisdictions, as opposed to a body that speak for a few of the most interested ones?

From my experience, the SEC confers continually with State regulators and bodies that speak for them and I think that making it more formal would probably slow down the situation, and I don't really think that that would be the productive way to move.

Mr. FIELDS. Thank you, Dr. Cox.

The gentleman from Massachusetts, Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman.

Professor Coffee, Mr. Beese cited statistics about the shrinking American share of global equity markets in recent years. First Mr. Beese said that we are losing market share in parts of some unregulated offshore markets.

In your judgment, do we need to race to the bottom of the regulatory barrel in order to compete effectively?

Mr. COFFEE. I certainly agree we don't need a race to the bottom. We shouldn't agree to remove those things that are fundamental.

I think there are areas, and I mentioned earlier the area of international accounting standards, where without saying the SEC's authority should be denied or crimped, where some attention might actually produce productive change. Just as we're seeing in the area of blue sky law, that the examination this committee is giving

to the process has produced a moving target, and we're beginning to see some significant change toward greater Federal and State coordination, I think that examination might produce somewhat better movement in the direction of international accounting standards.

Mr. FIELDS. Would the gentleman yield for just a moment?

Mr. MARKEY. I'll be happy to yield.

Mr. FIELDS. Professor Coffee, I want to reassert that the Chair would appreciate very much your comment in this particular area. I think it could be very helpful during this process and, as we said earlier, we're willing to look at any idea.

I thank the gentleman for yielding.

Mr. MARKEY. And we have been working, this subcommittee, for the last 4 or 5 years, with the Securities and Exchange Commission and the New York Stock Exchange in terms of the foreign listings, but it was important for us to ensure that American investors would understand that the German accounting system might overvalue by a third many of its companies and that the American investor, in choosing between comparable companies in the United States——

Mr. COFFEE. You're quite right, Congressman.

Mr. MARKEY. So the post-GATT, post-NAFTA world does lend itself now to that kind of harmonization and we're driving in that direction, both the Administration and those of us on this committee, working with the exchanges. I think in some instances the exchanges want to move a little bit too quickly to get the short-term benefit while unfortunately leaving investors in a more exposed position.

How much of the growth of foreign markets is attributable to the creation of new securities markets in places like Latin America, Eastern Europe and the former Soviet Union?

Mr. COFFEE. I think those new markets are basically growing because of the worldwide phenomenon of privatization. That is one of the new major secular developments in the securities markets.

Mr. MARKEY. So in other words, after World War II, we had a very large share of the world economy because most of the rest of the world was destroyed. And as the next 30 or 40 years unfolded, our share was reduced but our total economy had grown exponentially.

Similarly, as the rest of the world, with our encouragement, opens up their markets to this whole phenomenon of capital investment through exchanges, whatever, our share may go down even as we're enjoying this tremendous historic high in terms of our own markets.

And I think it's the duality of it all that we have to get used to, that we can't stand astride the world and, at the same time, encourage them all to participate in the same phenomenon and expect to keep the same share, although our economy grows much faster than the rest of the world.

Mr. COFFEE. I think that's entirely fair.

Mr. MARKEY. I thank you.

Now, Mr. Cohen, I confess that I am rather mystified by your testimony. Let me just ask this. Mr. Cohen said that the Enforcement Division was the tail that wagged the dog and we have three

of the dogs who are here; that is, three of the commissioners during that period of time.

I'd just like to ask you if you agree with Mr. Cohen's characterization of the way in which the commissioners, as the dog, was constantly wagged by the Enforcement Division. Did you have independent judgments you made, Dr. Cox, or was the Enforcement Division in charge?

Mr. CHARLES COX. I don't think that the Enforcement Division was wagging me.

Mr. MARKEY. Thank you. That's all I have to know. Mr. Beese?

Mr. BEESE. Congressman——

Mr. MARKEY. You were deeply involved in all of those enforcement actions, I know.

Mr. BEESE. I was and I know of no instance where the commissioners sitting at the table didn't exercise the ultimate judgment but can I just make one sympathetic point? I think it's important.

I did observe, however, that there are two ways that the Commission can, at times, do business. One is through enforcement actions and the other is through rulemaking. Let me just give an example.

For instance, the use of derivatives by U.S. corporations, let's say Fortune 500 corporations; the majority of them use them to mitigate risk. Several years went by where it was common knowledge that a lot of corporations were using derivatives to mitigate risk.

We could have passed an interpretive release telling how those should be accounted for and how they should be stated, as opposed to waiting for an enforcement case, and then that case is specific to an individual company and everyone else goes out and hires securities lawyers at tens of thousands of dollars, hundreds of thousands of dollars——

Mr. MARKEY. But that's a Commission problem. The Commission could have done it.

Mr. BEESE. Right. I agree.

Mr. MARKEY. It should have done it.

Mr. BEESE. Right. That's a sympathetic point.

Mr. MARKEY. You should have had a big public debate, but don't blame the Enforcement Division because you didn't do your—not you personally but the Commission didn't do its job.

Mr. Sommer?

Mr. SOMMER. I think it should be borne in mind that every enforcement case that the Commission brings has been preceded by two actions of the Commission. One, they authorize the formal investigation and second, they authorize the action. And while I have great respect for the Enforcement Division, I don't think that they were wagging me when I was there, even though that was a period of intense and extensive enforcement activity.

I think that the Enforcement Division has acted very responsibly and the Commission has acted responsibly. And, as you point out, Congressman Markey, if the Commission should have chosen rulemaking rather than enforcement activity as a means of policymaking, that was a Commission fault and not the fault of the system.

Mr. MARKEY. I thank you. I know my time has expired. I had a penetrating question for you, Mr. Cohen, on the basis of the response I thought I was going to get but my time has expired.

Mr. COHEN. I would just adopt Mr. Beese's comment.

Mr. FIELDS. The gentleman can ask an additional question.

Mr. MARKEY. Thank you.

So, Mr. Cohen, I am rather mystified by your testimony because you start out in your prepared remarks by noting the disturbing regularity of what, until recently, would have been, in your words, "once in a generation disasters," in your quotes. Specifically you mention the scandals at Daiwa, Barings and Kidder Peabody.

You then go on to talk of losses to a billion dollars or more with common themes of "illusory profits running for years of schemes with supposedly simple and reckless cores," and of "so-called rogue traders and certainly stupid, inattentive and perhaps venal supervisors." According to your testimony, regulators here and abroad have failed to forestall these financial disasters and provide confidence to investors. You then suggest than H.R. 2131 addresses the roots of these failures.

My problem is that I see nothing in your remarks which actually explains how the specific provisions of this legislation would actually help financial regulators address a future Daiwa, Barings or Kidder Peabody. Can you explain to us just exactly what provisions of this bill, if enacted, would have prevented these or similar scandals from occurring?

Mr. COHEN. The bill's provisions are designed to restructure securities regulation. I apologize if I am an opaque writer, to use the word that's been used today. The concept is to focus the dollars we have available for securities regulation in the most effective fashion.

It's my belief that the Commission, in spending 40-something percent of its budget on enforcement, of which 18 percent relates, as I understand it, to individual investors, is overspending with regard to people who make individual investment decisions, as opposed to protecting individual investors who invest through mutual funds and so on.

My view is that if the Commission spent more time on systemic problems, we would have fewer problems. And in fact, the Commission has adopted that because most recently its inspection group has said that in contrast to the past, they will now spend more time looking at risk management.

And to finish the point, I don't regard my views as those which would seek the elimination of the States in the securities regulatory process. Rather, I seek to give them an enhanced role in protecting individual investors.

Mr. MARKEY. Well, my problem is that reducing or getting rid of the SEC's respected Enforcement Division and scattering its functions to the various policymaking divisions would, in my opinion, make it much more difficult for the commissioners themselves to be able to focus upon, in their opinion at that time, what the most important problems were in the marketplace as a whole.

Then you would, instead, have a debate that was raging amongst all these various divisions rather than having an SEC looking at the Enforcement Division and using it as its weapon to deal with

whatever it was that they felt, at that time, was the most important decision. And amongst them, at that time, I would feel much more confident that the correct targeting would be done.

You, on the other hand, unfortunately seem to be hellbent on breaking up this Enforcement Division, which is, in fact, one of the most respected divisions of the entire Federal Government, in terms of its effectiveness over the years, while impugning the capacity for the Commission itself to oversee its activities. And I think that it's absolutely historically inaccurate in terms of the actual operation of the division.

Mr. COHEN. The Commission ran that way for some 40 years before it changed, so there's historical precedent for it. I'm not suggesting enforcement disappear. I'm just suggesting that the Enforcement Division be subject to the people who run the individual divisions who are, in turn, subject to the Commission. It's just a restructuring of the way the Commission operates.

And it would cause those divisions to have to act, as Mr. Beese said, through proposals, comments, hearings. That's how one should regulate, not through consent decrees.

Mr. MARKEY. I thank you, Mr. Chairman.

Mr. FRISA [presiding]. The Chair would note that the gentleman was granted some additional time because the subcommittee chairman did ask the gentleman to yield and he was kind enough to do so.

The Chair now recognizes the gentleman from California for 5 minutes.

Mr. CHRISTOPHER COX. Thank you. Before I move on to other questions, I'd just like to finish up the topic that we were discussing earlier and that is the relationship of State and Federal laws, in particular the utility of merit review. Mr. Sommer, you were mentioning, in your earlier testimony, that there really is a place for blue sky regulation of intrastate offerings and that price regulation does not apply to certain kinds of exempt issuances already, but I'd just make two points.

First, the bill we're discussing doesn't apply either to intrastate offerings in this respect. And there's obviously no duplication if it's an intrastate offering, so it's not a problem.

Second, with respect to initial public offerings, particularly of medium-size firms, there isn't any exemption, is there?

Mr. SOMMER. Not unless they're going to be listed on the NASDAQ NMS or on the exchange. I would have no objection to preempting State jurisdiction with regard to anything that is registered with the SEC. I have concern when it goes farther than that and would exempt from State regulation anything that is exempt from the registration and prospectus provisions.

But anything that is registered with the SEC, I would have no objection to preempting there.

Mr. CHRISTOPHER COX. I appreciate that clarification. That expresses my view, as well, and I'd just restate generally the question for the panel and if anyone objects to this notion, please respond.

In these circumstances, where SEC registration is required, are we wise to seek to avoid State attempts at regulating the price at which securities are offered?

Mr. COFFEE. I'd like to add one slight clarification on where the threshold should be. It might be that merit review is misplaced, and it is a very small concern of most States anyway, with regard to the company that is already a reporting company.

But I think there are companies below the so-called level of reporting company, below 500 shareholders, where I think close State scrutiny is particularly needed. It may not be a one-state offering—it may be a two- or three-state offering and there, merit review is often a substitute for close, careful disclosure regulation.

Mr. CHRISTOPHER COX. Well, let me ask the question with more particularity, then.

Mr. SOMMER Public offerings result in less than 500 shareholders.

Mr. COFFEE. I think we're only disagreeing about a very small stroke here, where it is a public offering that is not yet a reporting company. I think that is an area where some closer State scrutiny is justified. Once we get——

Mr. CHRISTOPHER COX. We are talking, in any case, chiefly about initial public offerings, so definitionally, these are not reporting companies.

Mr. COFFEE. Reporting company is a timing point. You become a reporting company later on, once you have 500 shareholders. During the initial public offering process, there are a number of companies that do have offerings and wind up with 300 or 400 shareholders, small, local offerings. I would be careful about sweeping them up in any broad prohibition of merit review.

Mr. COHEN. Mr. Cox, what I would say is Professor Coffee's point was made before and people may not have heard it. The States don't really look at merit regulation from a value standpoint. They're looking for overreaching by promoters in deals. It's a very narrow part that they're normally looking at.

And what you ought to ask when you have the State representatives here is how many of them do this, what kind of effort do they spend on it, what's their expertise like. I think you're going to find that there's minimal expertise in this area.

Mr. CHARLES COX. In answer to the question you posed, Congressman Cox, offerings that are registered with the SEC should not be subject to further review of any kind at the State level.

Mr. CHRISTOPHER COX. Let me switch topics, having explored this as fully as time allows, and talk about the expanded authority to issue exemptions that is the subject of proposed legislation.

Two of you at least have mentioned that you believe that whereas legislation we are considering applies only the the 1933 Act that it ought to apply both to the 1933 and 1934 Acts, so I will ask it this way. Is there anyone on the panel who does not agree that the SEC should have broader exemptive authority under both the 1933 and 1934 Acts? Dr. Cox?

Mr. CHARLES COX. I'm not responding to disagree; I'm responding to say to keep in mind there's more than the 1933 and the 1934 Acts. There's two 1940 Acts, as well.

In my written statement I referred to a situation where a perfectly reasonable action was withdrawn out of fear that court interpretation in response to special interests who are challenging it

would severely limit the Commission's exemptive power in that area, and it regarded one of 1940's acts.

So my point is look even broader than the 1933 and the 1934 Act, if you would, please.

Mr. SOMMER. I think the Commission has broad exemptive power under the 1940 Act, don't they? It already has it.

Mr. CHARLES COX. Well, it wasn't broad enough that they weren't afraid about losing it in this situation.

Mr. CHRISTOPHER COX. If the chairman would permit, I don't require another round of questions but I would wish to ask Mr. Sommer, because your testimony——

Mr. FIELDS. Would the gentleman just ask unanimous consent?

Mr. CHRISTOPHER COX. Yes, I would ask unanimous consent to put one additional question.

Mr. FIELDS. Without objection.

Mr. CHRISTOPHER COX. In your testimony you mentioned that in your view the $10 million threshold in H.R. 2131 for determining its status as an institutional investor is too low. What would you suggest is the appropriate threshold?

Mr. SOMMER. Well, I indicate in my prepared statement more fully than I did in my remarks here that I would prefer to see the committee leave the problem of suitability with the self-regulators and look carefully at the NASD new rule with regard to suitability as it applies to institutions.

If you were going to stay with the proposal that is in the bill, which essentially says that institutions above a certain size don't need the protections of imposing responsibility upon the professional with whom they deal, I would frankly go as high as $100 million.

You can have fairly unsophisticated people handling fairly sizable portfolios, and I would think that $100 million or something in that neighborhood would be a much more reasoned line-drawing than $10 million. At the $10 million level you get some people who are very unsophisticated and who I think need the protections that are afforded by some sort of suitability rule.

Mr. CHRISTOPHER COX. I thank the chairman.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from Michigan, Mr. Dingell.

Mr. DINGELL. Mr. Chairman, thank you.

Mr. Beese, in your statement you state that the costs imposed by securities regulation are becoming "a significant threat to the continued competitiveness of the U.S. capital markets." Isn't it true that the number of foreign companies seeking to list their securities on American exchanges and willing to comply with American disclosure laws is booming?

Mr. BEESE. It is, Congressman, but what's booming even faster is the number of foreign securities held by U.S. both individual investors and institutional investors. Five years ago our institutions held approximately 3 percent of their portfolio in foreign equities. Now it's over 10 percent. Individuals, we see all these foreign country mutual funds out there.

A lot of those securities are bought by U.S. investors but they're bought in offshore markets and not onshore markets, and I think there are ways. I agree with Chairman Levitt when he said that

our regulatory structure still looks more like the product of Rube Goldberg than Thomas Jefferson.

Mr. DINGELL. Why are American investors compelled to go into these offshore markets to buy? That's because the sellers of the securities do not wish to comply with the U.S. disclosure laws; isn't that right?

Mr. BEESE. That's correct.

Mr. DINGELL. All right. But Daimler Benz wanted to list its securities so badly in the United States that it complied with our strict accounting rules and, for the first time, disclosed to its investors the existence of a secret $1.8 billion fund that it had kept off its books.

Mr. BEESE. That's correct.

Mr. DINGELL. Isn't that right? And we also observe that there is an exponential growth in the size of the U.S. securities markets, the number of new offerings; isn't that right?

Mr. BEESE. That's correct.

Mr. DINGELL. And foreigners are coming over here to list their securities at record rates, are they not?

Mr. BEESE. That's correct.

Mr. DINGELL. And investors from around the world are coming over here to buy in the U.S. markets, are they not?

Mr. BEESE. They are. The size of global offerings today dictate that you have to do at least part of your offering in the U.S. markets.

What we found in Daimler Benz, and I was a strong proponent of that stand-off with Daimler Benz, that they should comply with U.S. GATT, but what we did find, both in that case and in the case of several other issues, including some of the privatizations that have taken place around the world, that there were ways that we could keep the threshold of protection that we currently enjoy but lower the cost. We did lower some costs for Daimler Benz to come to this market. We've lowered costs for some of these other privatizations to come into the market. I don't believe we've lowered a threshold of protection.

Rule 144A was a way to lower the cost of foreign issuers to come to the U.S. market, I think without lowering the threshold of protection. There are some ways we can do that, but we should never lower the threshold of protection. We should never allow a foreign company to list in the U.S. market at a standard lower than we require a U.S. company to list in the U.S. market.

Mr. DINGELL. We agree, but the high level of offerings in the United States by U.S. and foreign firms, the fact that major foreign corporations, like Daimler and others, would come over here indicates that the U.S. markets are appealing markets. It means that capital flows easily and comfortably, investors are comfortable coming over here, both from the United States and from other places; isn't that so?

Mr. BEESE. They come because of the integrity of our markets, but there are ways to keep that integrity but lower the cost for those issuers so that when those same investors buy other German and Swiss shares, they could do it onshore in the U.S. and through U.S. firms rather than offshore.

Mr. DINGELL. Well, let's look at the character of this market. It attracts huge numbers of peoples from all around the world. The disclosure which we have, the enforcement which we have indicates to everybody that we've got a fair market. People come over here. Isn't that right?

Mr. BEESE. That's correct.

Mr. DINGELL. And in this market a fellow will sit down, write a check for $1,000 or $5,000 or $10,000 or $50,000 to a guy he never met, send the check off to buy securities solely on the basis of the fact that he thinks that the system is fair, he's going to be protected, there's fair disclosure, there's not going to be any active fraud, that the disclosures that are made are truthful, that other experts are watching to see that these events are being fairly conducted, that the disclosure is adequate for the protection of their people.

So he comes to the conclusion that here he has an honest system on which he can invest huge sums of money. Well, thank you for that.

Mr. BEESE. Can I just be clear that in no way do I advocate a race to the bottom on standards. I maintain—I'm very proud of the work at the SEC I was a part of and today's SEC, maintaining very high standards.

We did find at the SEC over the past several years a way to keep those standards and lower the cost, and that's all I'm advocating.

Mr. DINGELL. Thank you very much.

Now finally, Professor Coffee, in your testimony, I note that the bill before us proposes limiting prospectus delivery only to those investors requesting it. Now, the average guy may not even know about a prospectus, may not know what goes on in it, but he might. But what this says is that we would convert a mandatory disclosure system into an optional one; isn't that so?

Mr. COFFEE. That was the criticism that I raised in my written remarks that you're reading, yes.

Mr. DINGELL. And the practical result of that would be those who most need disclosure will be not getting it.

Mr. COFFEE. I think that is a problem, yes.

Mr. DINGELL. And it also means that if a fellow doesn't want to disclose, he just says, "Well, we aren't going to make that disclosure available; we're not going to send it unless you request it."

Mr. COFFEE. I think that some broker-dealers—not all—will try to sell some offerings on all solicitations only from the broker and will not try to provide the final prospectus where it is optional.

Mr. DINGELL. Now, the purpose of the prospectus is to assure that the only document upon which and the only representations upon which the investor relies are those which are included in the official prospectus; isn't that right?

Mr. COFFEE. That's correct.

Mr. DINGELL. And so when an individual gets that prospectus, he is also informed that any other representations are invalid and that he must rely only upon the prospectus; isn't that right?

Mr. COFFEE. That is the advantage of that system, yes.

Mr. DINGELL. Thank you, Mr. Chairman.

Mr. FIELDS. The gentleman yields back.

The gentleman from Washington State, Mr. White.

Mr. WHITE. Thank you, Mr. Chairman. I appreciate it very much. I just want to follow up on a couple of lines of questioning that the gentleman from Michigan was engaged in.

No. 1, on the issue of costs, Mr. Beese, what are the costs that we're talking about here? You say that our system is expensive. I know that it requires the services of some pretty expensive lawyers. Are those the main costs we're talking about or are there other costs?

Mr. BEESE. The greatest cost in our system today is something that is the subject of another bill and not that bill, and that is frivolous and excessive litigation.

Mr. WHITE. I can agree with you on that.

Mr. BEESE. But with regard to regulatory costs, again I cite Chairman Arthur Levitt that at times our regulatory structure looks like it's the product of Rube Goldberg, not Thomas Jefferson.

Congressman Markey was correct that democracy has been—a by-product of democracy expanding around the globe has been healthy capital markets. But there also have been times where we have pushed markets offshore because of costs.

In no way should we ever lower the threshold of equality or integrity in our markets, but if we take a look, say, in 1963 when we put a 1 percent excise on foreign issuers coming to the U.S., it was a catalyst for the Eurobond market. That market could still be in the U.S., or at least portions of it. It didn't have to be pushed offshore in the way that it was in 1963. Granted, ancient history, but it does happen.

The OTC derivatives today, the net capital rules that exist at the SEC, they're under review but they never envisioned credit. And if we could have a provision for credit in our net capital rules, this business that gets done off-balance sheet at brokerage firms and offshore could be done on the balance sheets of the regulated entities and in the regulated markets, and those are some of the ways to do it.

The other one is what I alluded to that is an internal SEC issue; that is whether you act more by interpretive release, where you signal the market what you expect, or if you operate by individual enforcement cases, where everyone else in the marketplace has to hire legal counsel to figure out what that case means for them.

Mr. WHITE. Then the three specific examples of costs you mentioned, I guess one was the excise fee, the 1 percent from 1963.

Mr. BEESE. Right, the tax of 1963.

Mr. WHITE. Okay, we'll call it a tax. That's good. The second was just the opportunity of making credit available?

Mr. BEESE. Modernizing some of the anachronistic rules, and that includes our net capital rules. That also includes something that I think both the chairman and Congressman Markey have sponsored in H.R. 1495 which has to do with investment companies. We've pushed trillions of dollars in these offshore funds that also could possibly be domiciled in the U.S. because of certain parts of Section 3(c) and I think there is a provision working its way through that would correct some of the provisions in 3(c) and hopefully we'll get some of that money back onshore.

Mr. WHITE. Okay. And the third thing you mentioned was the legal costs that are required when the SEC decides to embark on

a new course. Instead of coming out with a market-wide approach, it moves on a case by case basis and they have to interpret that.

Are there other costs that other members of the panel can identify as excessive costs in the current system or things that we might be able to correct?

Mr. COFFEE. I do think printing costs are probably the most easily correctable because I think in the world of modern telecommunications, we can still have a mandatory prospectus but it can be delivered electronically in the near future.

Mr. WHITE. That's an excellent point. Yes, sir?

Mr. CHARLES COX. I would just like to mention the approach where I think it is very important to balance the effects on competition on efficiency with what you're getting out of a rule or interpretation as far as investor protection. It doesn't make any sense to say that they can be looked at separately because they're all intertwined, and certainly that should be weighed carefully. It often is, but I think that making that very clear, that it should be, would be advantageous and would eliminate costs to the regulatory system.

Mr. WHITE. Well, that's an excellent point and actually leads me to another question that I wanted to get into. I've had the pleasure of drafting portions of some of these disclosure documents and I've had the pleasure of trying to read some other ones, and if we're really trying to look out for the regular guy, it's my sense that the regular guy who gets one of these big prospectuses isn't going to be able to make heads or tail of it. We've got so much disclosure in there, he couldn't find the significant thing even if he wanted to.

So my sense is that these prospectuses, if they're useful, are useful to very sophisticated people who can analyze them using highly paid consultants. What do we do for the regular guy? What is your sense on how well these disclosure documents work?

Mr. COHEN. That's the way the system works. The system does not work on individual investors. It works on analysts who get this material and their input goes into the market price. That's what it's all about. The Commission, people from the Commission, people from the States, other observers have regularly said nobody reads these prospectuses except analysts and probably lawyers when they're about to sue someone.

Mr. WHITE. That strikes me as absolutely accurate.

Thank you, Mr. Chairman. I yield back my time.

Mr. FIELDS. The gentleman's time has expired. The gentleman from Pennsylvania, Mr. Klink.

Mr. KLINK. Thank you very much.

Just your last answer, Mr. Beese, led me to another question I wasn't planning on asking but as we take a look at the derivatives market worldwide, we've done pretty well in this country. I mean, companies like Citibank, Bankers Trust, J.P. Morgan, First Boston, Lehman Brothers do pretty well, given the current regulatory climate in this country.

Why change what seems to be working, is I guess what I would ask you.

Mr. BEESE. Because there are some anachronistic aspects of our regulatory structure and our rules, such as the net capital rule that

doesn't envision credit, that pushes us offshore. Some feel it's fine if this activity just—the undesirable element of that activity takes place offshore as opposed to onshore, but when you do that, to me, one thing happens. The risk stays in the system. We are in global markets; the systemic risk remains there. But a body such as the SEC has less reach over it because that aspect of that activity is taking place offshore.

I'd like to see it stay onshore and stay under the direct jurisdiction of the SEC, rather than having to rely on foreign regulators to try and control something that will affect our markets if there is an accident.

Mr. KLINK. Our markets do very well in competing, for example, with derivatives dealers in London. Are you saying that you want to see some of this undesirable business come onshore and you think that the SEC will be able to deal with that, and you're saying our investors are getting involved with it now offshore and there are no protections? Is that correct?

Mr. BEESE. They get involved with it more in off-balance sheet entities and a lot of this activity is booked, say, in offshore entities—the London departments. That just puts it a little further outside of the reach of the regulators.

I would rather see all this activity take place on balance sheet and be exposed to the full panoply of securities laws and to the full transparency. Right now, only because of the Market Reform Act of 1990 that this committee was instrumental in is the SEC able to look up into the holding company or into the off balance sheet subsidiaries to see the activity. Before that, the SEC didn't even have a chance to look at the books of those activities.

There are ways that we can structure it so that you could bring it inside the regulated entity, have better transparency to it to the regulators, and be able to have more direct authority over that.

Mr. KLINK. We may want to follow up. Before I go any further on this line of questions, I did want to ask Mr. Cohen a couple of questions.

As I look at page 8 and 9 of your testimony, and again, as with Mr. Coffee, I don't like to put words in anyone's mouth. I want to make sure I understand what you're saying.

You seem to be questioning the validity of what you refer to as a populist belief that excessive use of leverage led to a speculative bubble that resulted in the 1929 stock market crash. You go on to say then that securities credit regulation should essentially be repealed.

Do you really believe that excessive use of leverage was not one of the principles in the great stock market crash which, as I understand it, most historians of that period have concluded was?

Mr. COHEN. The use of leverage had some effect on the market but didn't cause the Depression, I think is the burden of the economic studies. At the time that the Section 7 was written into the law in the 1930's, the belief was there was a fixed amount of capital in the country and rather than it going to industry or to agriculture it was going into the market.

Whatever the truth of that at that time certainly doesn't exist today. There's lots of capital. If you just look at credit card capital

and that kind of debt, it vastly exceeds the amount of debt I think that exists in the stock markets.

Mr. KLINK. I don't want to run out of time and I want to cover a little bit of territory with you. What would you offer as evidence to support your conjecture that excessive leverage was not one of the principal factors that caused the crash?

Mr. COHEN. Again, I guess I'm not making my point. My point is not the question as to whether or not excessive leverage caused the market to fail. The question is whether it was a cause of the Depression. I doubt if excessive leverage affected the market, but that's not really my point.

My point is both the Federal Reserve Board in the 1970's and the New York Stock Exchange in the 1970's looked at Regulation T and the New York Stock Exchange was in favor of getting rid of Regulation T. That's where things are. There's no reason why credit regulation, why margin regulation shouldn't be as competitive as anything else. There's no reason why I shouldn't be able to go to Merrill Lynch and borrow at 90 or 95 percent on General Motors stock, as opposed to 50 percent on General Motors stock. Really the issue there is a net capital issue.

And especially today, if I could go on, Congressman, where institutions have a large amount of the security ownership in the country, then the debt concerns you would have have to do with where the institutions are, rather than any particular individuals.

Mr. KLINK. I see that you not only favor getting rid of the margin requirements for institutional investors but also for the Mom and Pop retail customers and stocks. Why do you want to get rid of the type of protection for the small investors?

I guess what I'm asking you, you state if we got rid of the margin limits for retail and institutional investors, as you recommend, "This would leave only the provision of Section 7, permitting the Federal Reserve Board to reinstitute regulation to deal with a financial panic." In other words, if we have a meltdown, then it kicks in.

Mr. COHEN. Congressman, you have read me exactly right. I don't believe it's in the interest of the economy for small investors to have margin regulation. I think they should be able to go out and borrow at whatever level they can manage. I don't think it's a securities regulation issue.

Mr. KLINK. The question that we have to deal with is if this is a prudent way of dealing with financial markets, getting rid of all the protections against excessive speculation—excuse me; let me just finish the question and I'll let you jump in if I can—getting rid of all the protections against excessive speculation and overleveraging except those that we would need in an all-out financial panic. I hate to get to that point.

Now please, I'll ask unanimous consent that the gentleman be allowed to answer.

Mr. COHEN. Thank you. I appreciate the courtesy of letting me finish my answer.

The concern that one should have is with the net capital effect on firms and their ability as counter-parties to meet their obligations in the market. The concern as to particular individuals should be limited.

Mr. KLINK. I thank the chairman.

Mr. FIELDS. The gentleman's time has expired. The gentlelady from California, Ms. Eshoo.

Ms. ESHOO. Thank you, Mr. Chairman.

I'd like to get back to Professor Coffee and where we left off. We were talking about companies that enjoy exemptions from State registrations and what their profiles were, of those that were required to register, et cetera, et cetera.

Typically, would these companies offer their securities to investors nationwide or might there, because of their size, the modesty of their size, cause them to limit their offering to their own State or region? My sense is that it would be the latter, but I don't——

Mr. COFFEE. I think you will see some regional offerings. Oil and gas offerings are often offered to an investment clientele that is in that region of the country. High-tech offerings may sometimes be offered more in California than elsewhere, again because it's costly to put together a nationwide distribution framework.

Ms. ESHOO. I read, I believe it was just last Thursday, that Myer Blinder, one of the most notorious penny stock swindlers of the last decade, was released from Federal prison. Quite a last name to go with the operation there.

Do penny stock operators generally work with listed or with unlisted securities?

Mr. COFFEE. They work with penny stocks, which are basically assetless companies—blank check, penny stock—there are several different definitions. They're generally companies with no real asset value and very little business plan.

Ms. ESHOO. For those companies that are required to register in States, are there really 51 or 52 substantially different sets of registration requirements? I think someone suggested that earlier. Do you have a sense of what the realistic breakdown is? Or is it that?

Mr. COFFEE. The most important point that I would make, and I think this is on the wavelength that you're asking, is that the small regional offering does not really attract the SEC's attention, particularly at a time when the SEC, even though the company is formally registering with the Commission, the SEC has a radar screen for its Enforcement Division that looks at the large national offering, the offering that's several million dollars and up.

I don't think that the SEC's radar screen can cover all offerings. The SEC does have to exist in a time of severe budgetary constraints.

Ms. ESHOO. Let me ask you this, then. Do you see any continued utility in permitting the States to exercise their rights to engage in merit review?

Mr. COFFEE. Well again——

Ms. ESHOO. Because you're saying on the one hand, this is what the SEC has to concern itself with; these are smaller operations; I guess the net is not cast all that wide. I mean, this bill does contain within the early shape of its language the end of merit review. So that's why I'm trying to differentiate how it works, who's covered, what the profile is, how these things are offered, who would be protected, who wouldn't. Meritorious examination of merit review, I guess.

Mr. COFFEE. Even where it's not merit review, disclosure-based regulation, where, because you are not listed on a major securities exchange or NASDAQ, you would still have to file and qualify in that jurisdiction simply under a disclosure system.

I don't think we should necessarily include merit review as the either/or question here. Many States will have a review system that is focussed only on disclosure but they will give much more attention to a local offering than maybe the SEC will because it is a very important offering.

Ms. ESHOO. And then how is that connected in a Federal sense, relative to the small investor? Is it simply that State operation? Is there a connection of the dots here or are they simply left on their own to do what you just described without any connection to the SEC?

Mr. COFFEE. I don't think that in the case of the IPO, the initial public offering, that there is that much coordination today. I think there is room for a good deal more coordination. Most of the coordination that exists exists among networks of States.

There are several different networks of State blue sky commissioners. I think that's a valuable trend and I think they will sometimes collectivize their response and realize economies of scale that way.

Ms. ESHOO. Mr. Chairman, I'd like to ask for unanimous consent for maybe just another half a minute.

Mr. FIELDS. The precedent has already been set. Without objection.

Ms. ESHOO. Thank you. In listening to the testimony, there's been several comments about 1965 and the cost of regulation and the year 1965, or 1963.

It's 1995. What relevance does 1963 to 1995 have? And I really would like to hear a 1995 case in terms of what these costs are without just adjectives. I mean numbers. Has anyone conducted any kind of study to demonstrate to this subcommittee what the costs are in 1995 which would then take us down a road of trying to repair that or presenting a provocative case, provocative enough case to us that something has to be done to not only save dollars but to broaden and strengthen our markets and protect investors? Can anyone answer that?

Mr. COFFEE. I'm not aware. I mean I can tell you average costs for an initial public offering but I can't tell you any aggregate national data, what was the total cost that goes into the legal system or the investment banking system for any particular discrete segment of the issuer community.

Ms. ESHOO. Is there anyone else that would like to comment?

Mr. SOMMER. I will not pretend to have that information but whenever you consider costs, I think you always have to determine what the benefits are. When you look to the benefits of an honest market, full disclosure, transparency, those benefits are extremely difficult to measure.

I have been involved personally in, I think, three endeavors to try to work out that equation. Costs—I'm sure there is data available with regard to what the costs of registration, of current filings and all that sort of thing are but measuring the benefits is just as important, and those are very difficult because an honest market,

a transparent market and an efficient market, those are very difficult to measure in economic terms.

We do know the market works well. We do know we have an honest market. We know we have a worldwide reputation for integrity and that is worth a great deal, but it's difficult to put a dollar sign on it.

Ms. ESHOO. Well, I appreciate that. That's why I'm trying to figure out what this overwhelming problem is in terms of our being so burdened or things being so costly. I mean, there were different adjectives and phrases that were used. I guess I should have written down who said it. That's why I wanted to pursue it.

Is it Mr. Beese?

Mr. BEESE. I used the 1963 example and——

Ms. ESHOO. And I don't know what 1963 and 1995 have to do with one another, 32 years later.

Mr. BEESE. It has to do with this. We were talking about the fact that the U.S. market share of global markets has declined substantially. Now, a lot of that is for the right reasons. A lot of that is because democracy has spurred the growth of capital markets in other countries, but I used 1963 as an example, that there have been times that we have, in fact, legislated our markets offshore. We did that with the Eurobond market. That was a rule that was passed in 1963.

Ms. ESHOO. But what about today? Because if the public indeed has confidence in this market, that really is the operative word.

Mr. BEESE. Absolutely.

Ms. ESHOO. You can't put a price tag on confidence. You can certainly start marking price tags when the confidence goes down, because there are losses across the board.

So if, in fact, we are enjoying this confidence, not only in terms of foreign investors but domestic investors, where are these burdensome costs and how do you weigh those if, in fact, again, confidence is like the cream that keeps rising to the top? What's the problem?

Mr. BEESE. The problem is that you can have a very high quality regulatory system, which we have today, at a high cost or you can find ways to lower those costs.

Ms. ESHOO. But you're not able to demonstrate those costs to me.

Mr. BEESE. Let me give you one rule that's been on the books since the 1930's.

Ms. ESHOO. I ask the chairman for a half a minute and I've gone way beyond his generosity.

Mr. FIELDS. Without objection.

Ms. ESHOO. I would like to ask anyone from the panel, if I might, if you can bring forward information that actually documents, and not just one specific case, but something that is broader than that that would convince the majority of us here that the costs that are I think being characterized as being so burdensome, that would be helpful to me and I think to others, as well.

Thank you again and thank you, Mr. Chairman, for your generosity of time and patience.

Mr. FIELDS. In the spirit of generosity, Mr. Beese, you had one example you were going to cite.

Mr. BEESE. The example of the short-short rule. It was passed in the 1930's. It has long outlived its usefulness. The House has passed its repeal three times, the Senate has passed its repeal twice, and it's never made it into a signed bill.

There are a number of anachronisms such as that, such as the ones I mentioned in H.R. 1495 that are attempting to be corrected with the Section (c)(3) proposals that we can do. Those anachronisms can continue to be taken out.

We've found a lot of ways to do that at the SEC. They're finding more ways today, and that's just a process that should continue. I think everybody's moving forward in that spirit.

Mr. FIELDS. Thank you very much.

The gentleman from Washington State, Mr. White.

Mr. WHITE. Thank you, Mr. Chairman. I can tell you that I, for one, am convinced that there are excessive costs and we ought to do our best to try to make the system both very high quality but also as efficient as possible.

And along those lines, Professor Coffee, you said you had a number for the cost, the average cost of an initial public offering. Can you give us what that number is?

Mr. COFFEE. I can tell you that the average underwriting discount is probably going to be in the neighborhood of maybe 6 to 8 percent. I can tell you that law firms in some parts of the country where they're expensive, like New York, can probably be expected to do the preparation of a Form S–1 for a number that today might be in the neighborhood of $100,000 or more. It wouldn't be cheaper than that for a new S–1.

Mr. WHITE. I can tell you we can do it a lot cheaper than that in Seattle, so just keep that in mind. So you're saying about $100,000 is about the minimum you're going to be able to do this for in legal fees?

Mr. COFFEE. If we're talking about a nationwide initial public offering, which is why you might go to a New York law firm with a New York investment banking firm, which is going to be a large offering, that would be the kind of level for the legal fees. Proper disclosure takes time and it is costly.

Mr. WHITE. And I absolutely agree with that. I frankly think $100,000 is an awfully low number, even for a public offering at a New York law firm, because that doesn't buy you a whole lot of New York lawyers' time. My sense is that's probably on the low end of what you could expect.

Let me ask you what we're getting for our money here, and this goes along with comments that Mr. Cohen was making earlier. I recognize, and I think you're absolutely right, that when we hire all these lawyers to draft these lengthy prospectuses, we recognize that the average investor is not going to read them but that analysts will and that information will get out to the marketplace.

On the other hand, this system was adopted, I think, in the 1930's with the idea that maybe the average person would read them, and we have a system that's kind of based at least partially on that premise.

Is there a better way for us to provide disclosure to these analysts, who need the disclosure, recognizing that we're now operating on about a 60-year-old system? Is there a more efficient way

to provide information to the people who are actually going to use it than the one we currently have?

Mr. COFFEE. Congressman, you're going to see such a system unveiled in about a month from the SEC, the company registration model, but it is not focussed on the initial public offering. Initial public offerings do occur against the backdrop where there is no efficient market operating, where it is an arbitrary pricing decision between the underwriter and the issuer, and where individual investors are making decisions in terms of the risk level of this company, where they do need individualized disclosure.

Once you get to the backdrop of a trading market that's efficient, then I think the costs can be substantially economized and you'll see the SEC outline one such model very shortly. And it may be that full implementation of that model would require exemptive authority.

Mr. WHITE. I appreciate that. Other comments? Mr. Cohen?

Mr. COHEN. What I would say is that one of the aims of this bill, and it's really been very effective so far, is to restructure securities regulation and refocus it. The Commission's major positive effect on the markets has been to channel information from issuers to the market.

That's in danger of being swamped now by multiple sources of information. You can talk to CEOs on the Internet. With regard to the prospectus, for example, as a file document, one can have access to that on the Internet.

So that's really going to be the question for the Commission's thinking over the next 5 to 10 years, which is how to continue to channel information when information comes about from multiple bases.

Mr. SOMMER. But I think it should be borne in mind that there's a cost that's involved with getting the information, putting it together, preparing it. No matter how it's disseminated, there's a great cost involved in getting the information and making sure it's accurate and full.

The same thing with accounting. The cost to most companies for their annual audit is very substantial. That is paid simply because it adds to the credibility of that information, and I don't think that the committee should look to the idea of doing away with such costs as those involved in audits, those involved in preparing documentation and information that is accurate and credible.

Mr. WHITE. I think that's an excellent point. As somebody who's participated in the creating of some of these documents, though, I would have to say that sometimes total, full disclosure isn't really the goal. I mean, the goal when you're preparing a lot of these documents is to make sure you say things in as negative a way as possible so that if something happens in the future, nobody could say you didn't disclose something, even if you don't think it was going to happen.

I just wonder if there are some changes we could make to improve the quality of disclosure and reduce the cost, recognizing that we came up with this system at a time that was much different from the time that we have now.

Mr. COHEN. I go back to what Mr. Sommer said before. Probably the greatest cost saving would be to understand that we have an

integrated market at this point and there's disclosure out in the market already. And to continue liability for underwriters in those kinds of settings is really unnecessary and just adds to the cost without any public benefit.

Mr. WHITE. Thank you. I see my time has expired. Thank you very much.

Mr. FIELDS. The gentleman's time has expired. The gentleman from Michigan, Mr. Dingell.

Mr. DINGELL. Thank you, Mr. Chairman.

I'm just sitting here reading an article "Bulls Have Been Cowed in Overseas Markets" on the front page of today's Wall Street Journal financial section. It says as follows: "Amid the misery, one bright spot has been the U.S. market, which has climbed 12.5 percent a year so far this decade, as measured by the Standard & Poors 500-stock index."

It goes on to say, "Indeed, for folks outside the U.S., the 1990's have been an investment disaster. Their domestic stock markets have taken it on the chin."

It goes on to say, "The rotten performance of overseas markets, and the stellar returns of U.S. stocks haven't gone unnoticed by American mutual fund investors." It goes further and says, "International investing is clearly unloved."

This tells me that the U.S. markets are viewed favorably by U.S. investors and investors elsewhere around the world. Am I right in that?

Mr. COHEN. Absolutely.

Mr. DINGELL. And one of the major components of that is the disclosure, which enables a fellow to think, "By golly, I'm going to be fairly treated when I enter this market." Isn't that right?

Mr. COHEN. Correct.

Mr. DINGELL. Now, Mr. Cohen, you bring to this gathering here, I think, a rather special view. You're a representative essentially of the bar that defends against enforcement actions taken by the SEC, are you not?

Mr. COHEN. No, I'm not. I do——

Mr. DINGELL. What is your practice?

Mr. COHEN. Let me see if I can try to explain what I do. I have a very complex day, like all of us do. I do a lot of advice on regulation for clients. I give a lot of advice as to net capital rules, as to dealing with their present set-ups.

What's happening in the brokerage industry is people looking at the business have determined that agency business—that is, doing Commission business—isn't as profitable as the principal business—trading for their own accounts. If you look at what's happened on Wall Street, Mr. Dingell, 25 years ago Morgan Stanley's capital was $7.5 million. It's $13 billion today. The difference is principal trading.

So people are looking at those kinds of regulations, thinking about doing them overseas where there's less regulation, and that's what I do most of the time. I do a certain amount of securities regulatory defense work.

Mr. DINGELL. Now, you just mentioned something which I regard as very important. The capital of U.S. investment houses, securities houses, has grown enormously, hasn't it?

Mr. COHEN. Yes, it has, sir.

Mr. DINGELL. Their stocks are now listed on the market. They're doing splendidly. As a matter of fact, a lot of them are recommended by Wall Street houses as good investments for the ordinary small investor, as well as for the big investor. Isn't that true?

Mr. COHEN. I don't follow the brokerage stocks. I'm sorry.

Mr. DINGELL. Well, as a matter of fact, I don't really do a very good job of it but I have noticed that.

Now, gentlemen, thank you. I appreciate your presence here and your assistance to the committee.

Mr. Fields, I want to thank you, Mr. Chairman, for your kindness in holding this hearing and for the very fair way in which you've conducted them. Am I to assume that the SEC, State securities regulators, and investors are to be heard at a future time?

Mr. FIELDS. You are.

Mr. DINGELL. I am? Good. In that, Mr. Chairman, I am mightily comforted and I thank you for that.

Mr. FIELDS. In fact, the gentleman may be interested to know that a request was made as late as yesterday afternoon regarding two witnesses on the panel and we felt that there was a great need to accommodate and we look forward to any suggestions that you might have regarding future witnesses.

Mr. DINGELL. Mr. Chairman, I want it to be known that I have great respect for you, great affection for you, and you have conducted the business of this subcommittee fairly and well, and I commend you for it and I salute you for it.

Mr. FIELDS. I thank the gentleman for his statement.

Before I yield to my friend from Massachusetts, I believe the gentlelady from California had one comment she wanted to make.

Ms. ESHOO. I did. Thank you, Mr. Chairman.

I guess Mr. Dingell and myself are both looking at the Wall Street Journal. I would recommend, if you haven't had time to read this yet today, that you refer to it because it does underscore what several of us have touched on here. I think that it brings the burden to you, so to speak, to convince us of what else needs to be done to build on a market that already has a great deal of confidence in it, I guess getting back to the report that I asked for or study in terms of the costs and whatever, where it's actually documented and not just anecdotal cases.

So I'm thrilled to read what they say in this article and I appreciate the chairman recognizing me. And thank you again for testifying.

Mr. FIELDS. The gentleman from Massachusetts.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

Are there lower regulatory barriers in Japan than there are in the United States? Is there less regulation there, Mr. Cohen?

Mr. COHEN. I can't——

Mr. MARKEY. Is there a less costly regulatory system there?

Mr. COHEN. Well, the Japanese system is built in with all kinds of inefficiencies and works apparently differently than ours in the sense that people go over to the Ministry of Finance and whatever the regulations are, they get guidance, as it's called. So I really can't say.

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It's also a kind of stratified market. There's a large amount of bank involvement in the market. It's very different than our market. It's a very efficient market at this point.

Mr. MARKEY. I agree with you. It is very efficient. Is their system of regulation less costly than ours?

Mr. COFFEE. It actually is a merit system, exactly the kind we're talking about getting away from, because the Ministry of Finance has to approve every issuance of capital by a Japanese company, and they are very, very restrictive about doing so.

So I don't think it's a model of anything like we're likely to move in the direction of.

Mr. MARKEY. And how about in England? Is it less regulatory there? I mean, the Barings Bank, what kind of regulation——

Mr. COFFEE. England does not have an SEC. In recent years it does have a securities board that is more like an NASD, but it has liability rules that we originally copied in 1933, but it doesn't have anything like an administrative agency of the complexity of the SEC.

Mr. SOMMER. Mr. Markey, may I make a point with a quotation that's in my prepared testimony?

Mr. MARKEY. Go ahead.

Mr. SOMMER. In 1987 the UK substantially revamped their regulatory system. At that time The Economist magazine, a well-known conservative publication, said the one thing we want to avoid in this country above all else is an American-style SEC.

In 1992 it said in an editorial, "It is time to seek virtue elsewhere in statutory rule by a single, independent body. Britain needs the equivalent of the American Securities and Exchange Commission." Mr. MARKEY. So why reinvent the wheel if there's something you can copy that's already working in another country?

You know, we spend a lot of time in this country engaging in unjustifiable self-hate in a lot of ways, as though somehow or other our deliberations and our experience is inferior to that in Japan or Germany or England when, in fact, and the 1980's are a good example, where their banking system was the model of the world and our economy was going to go to hell on a handcart unless we followed their banking model, and Japan.

And today we look at it—they're looking at their own in a rearview mirror—wondering how in the world they ever allowed something to get so far out of control, in terms of the long-term impact it can have upon their own economic growth. Matal Geshelshaft in Germany, Barings in England, should give us, on an on-going basis, sufficient warning as to how much we can learn from the rest of the world and how much they can learn from us.

I think that we should fine-tune. I think we should be smart; we should update. But, on the other hand, I don't think that we should stand by as our markets are the envy of the world and allow for the rest of the world to somehow or other become a model for us.

There's $400 billion worth of bad loans in Japan right now, like an anchor taking it to Davey Jones' locker. And on their financial disaster, on their lack of proper financial monitoring in their marketplace will come our great economic opportunities in the 1990's. So I think that that's the one thing that I would like to have noted at this time.

One final question, if I could. It's not directly relevant but it is in a lot of ways, given what's going on in the rest of the world.

There's a Senate proposal right now to cut the SEC budget by 10 percent, which would effectively cut all personnel by 20 percent at the SEC. Is that a good idea or not, Dr. Cox?

Mr. CHARLES COX. It's been a long time since I've studied budgets at the SEC but I think in the context of cutting government spending, I would be surprised if adopting something like privatizing EDGAR, things along those lines, if a 10 percent cut couldn't be withstood full well while still keeping a strong enforcement presence.

Mr. MARKEY. Mr. Beese?

Mr. BEESE. Congressman, certainly in Japan and the other markets you cited, the real difference is the lack of enforcement. In fact, Japan is exactly the opposite—heavily overly regulated and very little enforcement.

I would like to see the enforcement budget for the SEC increased. However, I do think there are ways that you can eliminate some redundancies; there are other parts of to SEC that can be streamlined. I would certainly agree with privatizing EDGAR. There are other aspects of that operation that could be privatized or there are some of——

Mr. MARKEY. The House budget is at level funding.

Mr. BEESE. Right.

Mr. MARKEY. The Senate is a 10 percent cut. Which would you vote for?

Mr. BEESE. It's a bit more complex than that. I'd like to see more money, more money for enforcement, even more than is proposed in both.

Mr. MARKEY. I know it's more complex but——

Mr. BEESE. But I do think there are other ways that other costs can be taken a look at, so just a simple answer between the two doesn't work.

Mr. MARKEY. I appreciate that. But part of the recommendation is to cut back State enforcement, as well. So if you cut back both in a market that's working—Mr. Cohen?

Mr. COHEN. I don't advocate a cut back of State enforcement. My statement is for increased State enforcement in the fraud area to pick up from the Commission where I think the Commission ought to set standards. I would believe that the Commission's budget could be cut. I would, unlike Mr. Beese, believe that more money ought to go into market regulation, to look at systemic problems.

Mr. MARKEY. Mr. Coffee?

Mr. COFFEE. The SEC is a money-maker. It generates a surplus every year. Every dollar given to the SEC actually will reduce the national deficit. I do not see any argument for reducing cash to a money-maker. It's a good return on your investment.

Mr. MARKEY. Thank you. And Mr. Sommer?

Mr. SOMMER. My experience at the Commission and since then has always been that the Commission was very prudent in the way it spent money. I think that among government agencies I think if there was a comparison made you would find you get more bang for the buck out of the money that's spent at the SEC than perhaps anywhere else in Washington.

Mr. MARKEY. I agree with you. Thank you, Mr. Sommer. Thank you, Mr. Chairman.

By the way, excellent hearing, Mr. Chairman. This is a fabulous panel.

Mr. FIELDS. I was about to point out that I think we've had excellent member participation and interest, which in and of itself is a good result of the introduction of the piece of legislation.

I know Mr. Frisa has additional questions and perhaps people on the other side of the aisle. I'm going to ask them at this point to withhold and submit the questions in writing to our panel.

I just want to close with several thoughts. First of all, I think it's the duty of the chairman to stay focussed and provide leadership, particularly in an area as complex as this area is and particularly when there's not been a significant review in over 50 years.

You were asked to appear today because of your expertise, not because of a harmonized viewpoint. So I would ask that after having heard your colleagues give their testimony, I would appreciate further correspondence relative to the legislation and relative to the comments that you've heard from our subcommittee members.

As I heard you today, I heard unanimity that this review should take place, that there have been positive developments since the introduction of the legislation. I thought I heard unanimity or I know I heard unanimity that investor protection and market transparency under no circumstances should be compromised, that we do have the greatest market in the world; unanimity that some things could be changed without compromising market security and investor protection but instead, things changed to promote market efficiency and to end things that are duplicitous, and I would really appreciate further comments in that particular regard.

With that, the subcommittee stands adjourned.

[Whereupon, at 12:55 p.m., the subcommittee was recessed, to reconvene at the call of the Chair.]

[Additional material submitted for the record follows:]

GOVERNMENT FINANCE OFFICERS ASSOCIATION,
MUNICIPAL TREASURERS' ASSOCIATION,
NATIONAL LEAGUE OF CITIES,
NATIONAL ASSOCIATION OF COUNTIES,
U.S. CONFERENCE OF MAYORS,
October 23, 1995.

The Honorable JOHN D. DINGELL,
Ranking Minority Member
House Committee on Commerce
2322 Rayburn House Office Building
Washington, DC 20515

DEAR REPRESENTATIVE DINGELL: The above organizations representing state and local governments write regarding H.R. 2131, the Capital Markets Deregulation and Liberalization Act of 1995. We are disappointed that no representative of any state or local government organization has been invited to testify at the hearing to be held tomorrow by the Subcommittee on Telecommunications and Finance on a bill that has enormous implications for state and local government investors and taxpayers and the financial markets in which they operate. In government securities alone, for example, state and local governments held $480 billion of the total U.S. Treasury debt of over $4.8 trillion as of the first quarter of 1995. This represents approximately 17 percent of the federal securities market not held by foreign investors or federal agencies.

In addition, we are particularly concerned about the provisions of the bill that would eliminate the suitability obligations of broker/dealers to state and local governments. As you are aware, a number of state and local governments have experi-

enced investment losses, not only recently, but over the past decade. Because of these losses, and the fact that many of them could be traced to the egregious actions of broker/dealers, Congress enacted the Government Securities Act Amendments of 1993. The committee report accompanying the new law specifically stated that distinctions based on the size of an entity's portfolio could not be made in sales practice rules written under this law. Regulations written by the National Association of Securities Dealers (NASD) and recently submitted to the Securities and Exchange Commission for approval under this law make it clear that broker/dealers have a suitability obligation to *all* institutional investors, with the NASD guidelines particularly applicable to those with portfolios of $10 million or more.

We believe that H.R. 2131 would reverse the protections provided for state and local governments and public pension funds, many of whom are more similar to retail investors than they are to large institutional investors but who nevertheless may have considerable sums of money to invest. Many finance officers have a number of other duties to carry out in addition to their investment responsibilities. Many jurisdictions are unable to afford highly skilled investment experts—either public or private—to handle their funds. These jurisdictions seek to maximize their earnings but must rely on the broker/dealers with whom they deal to provide them with sufficient, accurate information to make these determinations. We have no desire to shift our investment responsibilities, but we fear that H.R. 2131 will instead provide a means by which broker/dealers can avoid their legitimate suitability obligation and that it will lead to further state and local taxpayer losses.

We hope you will urge the subcommittee chairman to solicit the opinions of state and local governments during the upcoming hearing process and that you will consider our views carefully before moving ahead with this legislation. Rather than aiding in the attraction of capitol—the stated purpose of the bill—we believe that this legislation will only serve broker/dealers' interest in protecting themselves from liability and could end up being costly to state and local governments and their taxpayers.

Contacts:

GFOA, Betsy Dotson, 202/429-2750; MTA, Stacey Crane, 202/833-1017; NLC, Frank Shafroth, 202/626-3000; NACo, Ralph Tabor, 202/393-6226; USCM, Ed Somers, 202/293-7330.

CAPITAL MARKETS DEREGULATION AND LIBERALIZATION ACT OF 1995

THURSDAY, NOVEMBER 30, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON COMMERCE,
SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:35 a.m., in room 2123, Rayburn House Office Building, Hon. Jack Fields, (chairman) presiding.

Members present: Representatives Fields, Oxley, Gillmor, Klug, Cox, Deal, Frisa, White, Coburn, Markey, Gordon, Furse, Eshoo, Klink, Collins, and Dingell (ex officio).

Staff present: Linda Dallas Rich and David L. Cavicke, majority counsel; Consuela Washington and Tim Forde, minority counsel.

Mr. FIELDS. Mr. Chairman, first of all let me apologize to you for the delay, and also too to the people in the audience.

Today we have the second in a series of hearings on securities reform and H.R. 2131, The Capital Markets Deregulation and Liberalization Act of 1995.

We are fortunate to have two distinguished witnesses, The Honorable Arthur Levitt, Chairman of the Securities and Exchange Commission, and the Honorable Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve. Mr. Greenspan will be testifying later this afternoon.

At the first hearing we held on November 14, we heard from a number of leaders of the securities industry. And we are looking forward to building on the fine dialog that resulted from that hearing as we discuss this legislation with the two distinguished regulators testifying today.

Arthur Levitt is involved in an extremely constructive interaction with both the elected representatives on the Hill and with the leaders of industry. And for that, I must say, I really appreciate that, Mr. Chairman, the dialog that has been initiated.

Alan Greenspan is an outstanding leader of the Federal Reserve and we are delighted to have his valuable insights on the question of margin reform and any other issues that he wishes to touch upon.

We've embarked on a historic effort to modernize the system of regulation affecting the capital raising process. Everything is on the table for discussion. We have heard practically universal agreement that it is worth having a rigorous and substantive discussion about the issues addressed in each section of the legislation.

Each section deals with a problem area in our capital markets. Impediments to capital formation are duplicative regulation that serves to raise costs to American business without providing incremental protection to investors.

I'm going to outline in brief some of the main provisions of the Capital Market Bill, highlighting what we have learned so far in this process.

On the question of the creation of a national security market, we're starting from scratch, basically. And few would argue that we should not have 52 separate regulators of securities offering.

We have a national system of regulation of offerings provided by the SEC. We think the SEC is doing a good job regulating these offerings. The cost of State regulation of offerings is considerable.

There is however, an important role for the States in our securities markets, specifically enforcement against securities fraud. Under the bill, States with have their own anti-fraud statutes, similar to Federal law that will enable them to police against securities fraud.

Also under my bill, the States can continue to collect fees on securities offerings. It's not our intention to take any money out of State treasuries.

My bill harmonizes regulation of securities offerings by making the SEC standard the national standard. This will save firms hundreds of millions of dollars in compliance costs, as estimated by Congressional Research Service.

These costs are borne disproportionately by small firms. They represent a significant barrier to capital formation. With this barrier is lost opportunity for American companies and lost jobs for Americans.

We learned in the first hearing that under a new European Union directive, a company that registers its offering in one member company will be deemed registered by all European Union countries. Witnesses suggested in our first hearing that offerings with the SEC should be exempt from State registration.

These are ideas that are worth discussing rationally with all interested parties, and we plan to do so. We are engaged in a constructive dialog with the States on this issue.

On the question of institutional suitability, in a nutshell, we think that sophisticated parties should decide for themselves what suitability requirements, if any, they want, and they should do so explicitly by contract.

Sophisticated institutional investors with more than $10 million in marketable securities under management usually have fiduciary duties to their investors, not to mention sophisticated staff.

We do not think that they should expect to be able to put losing investments back onto their broker, on the grounds that the investments were unsuitable, unless they have explicitly contracted for investment advice. This clarification will avoid expensive litigation by parties who are merely unhappy about an unsuccessful investment decision.

On margin reform, one of the ideas that underlines my bill is that efficiency in capital formation can be promoted by recognizing that sophisticated parties can be treated differently under the securities laws than is my 70 year old mother. I think that it is obvious

that there are different issues involved when two global investment banks are dealing with each other rather than with a small retail client.

Institutions have access to real time information on earnings and corporate performance, and extensive access to professional securities analysis. This informational advantage, coupled with the sophistication and care they bring to managing their money, renders some rules more burdensome than helpful.

The margin rules currently in place set different rules for lending by banks and by broker dealers. This is a distinction that makes no sense at all. They also prohibit broker dealers from borrowing from anyone other than a commercial bank when using margin stock as collateral.

This anti-competitive prohibition has the effect of raising the cost of doing business for brokers who are precluded from lenders like insurance companies or other brokers.

I have proposed reform of these rules, as has Chairman Levitt. I look forward to the comments of Chairman Levitt and Chairman Greenspan on this topic.

Realizing that we are running a little bit late, I am going to ask unanimous consent to place the remainder of my statement in the record so that we can move forward.

[No response.]

And at this time the Chair will recognize the gentlemen from Pennsylvania for any opening statement.

Mr. KLINK. Thank you very much. And I indeed will be brief. Mr. Chairman, I am pleased that you are holding another hearing on H.R. 2131. I am grateful for you inviting Chairman Levitt today to testify on the bill today.

It's always good to hear from our Federal watchdog. I consider Chairman Levitt to be a voice of reason and responsibility on these issues, and I'll be anxious to hear what he has to say.

I'm also glad that we're going to hold at least another hearing on this bill next week, when I understand we're going to hear from State regulators and others. I think that's good.

Mr. Chairman, as I've said before, I still have serious reservations about this bill, but I commend you for the hearings and what is truly becoming a very deliberative process in taking a look at this bill. I look forward to today's testimony and I'll cut my comments short and yield back.

Mr. FIELDS. The Chair thanks the gentleman. The gentleman from Georgia, Mr. Deal.

Mr. DEAL. Thank you, Mr. Chairman. I too will be brief and commend you for holding this hearing. And I certainly look forward to the testimony of the two most distinguished chairmen on these subjects, and look forward to their testimony and thank them for being here.

Mr. FIELDS. The Chair thanks the gentleman. The gentlelady from California.

Ms. ESHOO. Thank you, Mr. Chairman. I too would like to commend you for holding these hearings. I'm glad that we're going to have another one.

And welcome to the very distinguished chairman of the SEC, Mr. Levitt, who in previous testimony on some other issues, in his

words that in this country we have the broadest, deepest markets. And that the markets are such because investors have confidence in them, that is the operative word.

So what you have to say to us, I think, will weigh heavily into our deliberations on this issue and the bill that's before us. And I'm very, very pleased that you are here and look forward to your testimony today. Thank you.

Mr. FIELDS. The gentlelady yields back. The gentlelady from Oregon.

Ms. FURSE. Thank you, Mr. Chairman. I also look forward to the testimony. I won't have an opening statement. Thank you for holding this hearing. And I yield back the balance of my time.

Mr. FIELDS. Mr. Chairman, this is about as quick as this panel has ever operated on opening statements. And, I think, in large part due to the fact that you have a very busy schedule. We appreciate your time and again apologize for the delay that we had in the hearing today.

And with that, the Chair would like to recognize you for 10 minutes. I believe you requested 10 minutes for your opening statement?

STATEMENT OF ARTHUR LEVITT, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. LEVITT. Thank you for your continuing courtesy. I appreciate this opportunity to testify on behalf of the SEC regarding H.R. 2131.

Mr. Chairman, in the months since you announced this legislation, the Commission has remained silent. I assure you that this is not because of any lack of interest. It's because the ideas introduced were big and we feel they deserved a thoughtful, measured response.

The Commission has taken H.R. 2131 as a challenge to further improve the state of our capital markets. Certainly the fact that those markets are functioning well right now doesn't mean that they couldn't function better. With that in mind, we undertook a detailed analysis of the proposed legislation which we submit to you today.

I think this is actually a good time to take a fresh look at the laws that govern our securities industry. Recent years have seen a massive movement of American investors away from the more traditional investment vehicles and into our stock markets.

I guess that I am concerned that many of those investors are first time investors, investors who haven't really seen a down market in nearly 14 years. One in three U.S. households now holds an investment in the market.

In the last 5 years our capital markets have outdistanced both commercial bank deposits and home ownership as American's primary means of building a sound financial future. This dramatic growth presents new opportunities for businesses, new opportunities for investors, and maybe more importantly, new challenges for Congress and for regulators.

We need to keep the framework of securities regulation up to date. And we need to foster market growth and development while at the same time providing effective investor protection to sustain

the confidence that plays so large a role in the success of our markets.

I've worked in our markets for most of my life. And that experience has led me to conclude that capital formation is best served by an agency whose mission is investor protection above all else. Investor protection strengthens capital formation.

I am convinced that there is a dollar and sense value to investor confidence that transcends every rule, every regulation, and every law, and makes ours the best capital market in the world. I believe that every rule, regulation, and law must be framed in terms of enhancing that confidence.

I support those initiatives that hold investor protection supreme, and have the most serious reservations about any that could diminish the perception of the reality that public interests are preeminent.

H.R. 2131 contributes some provocative ideas about overseeing our markets. I've always felt that it's healthy to question your most basic assumptions. And I think Chairman Fields deserves credit for encouraging a fresh look at securities regulation. We've all lamented the duplication that occurs in our combined State and Federal system of securities regulation.

The Capital Markets Bill has helped move the dialog forward to the point where the SEC has just this week held a planning summit with all regulators who conduct SEC examinations of broker dealers: the NASD, the New York Stock Exchange, the AMEX, the CBOE, and on behalf of State securities authorities, the North American Securities Administrators Association. I am pleased to announce today that at this summit held just 2 days ago, we signed a memorandum of understanding that will provide for much better coordination of broker dealer examinations by all regulators.

Dialogue with State regulators has also revealed a growing consensus on ceding primary responsibility for many investment advisors to the States, and for investment companies to the SEC. Of course, this could only be effected through legislation.

That's not to say that the Commission agrees with every single point in H.R. 2131. And in many cases, even when we do agree, we believe that change can be effected through existing authority or through private sector initiatives rather than through more legislation.

We feel that rescinding the Williams Act would deprive investors and companies alike of vital information and protections, for example. And in light of the new suitability rules proposed by the NASD, we would allow the rulemaking process to run its course before imposing legislative solutions in this area.

But even where we disagree with the answers, we feel there is enormous merit in the questions. It's my sincere hope that now that the dust has settled from the initial announcement of this bill, we can all sit around the table and arrive at a consensus on ways to improve our markets.

This is not a cause that belongs to any party. American investors and America's markets deserve the very best bipartisan effort we can put forward. Change has always been the hallmark of our markets. And the SEC has succeeded by recognizing that fact and by responding to it.

We welcome the opportunity to work with you, to work with the Congress, to make our markets work better for investors and for companies alike. Thank you.

[The prepared statement of Hon. Arthur Levitt follows:]

PREPARED STATEMENT OF HON. ARTHUR LEVITT, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Chairman Fields and Members of the Subcommittee: I appreciate this opportunity to testify on behalf of the Securities and Exchange Commission ("Commission" or "SEC") regarding H.R. 2131, the "Capital Markets Deregulation and Liberalization Act of 1995."

Today's markets are vibrant and growing. They serve the needs of more than 12,000 public companies, raising capital to support new industries, finance operations, create jobs, fund research and development, and support growth for the future. In 1994 alone, over $800 billion of securities were registered with the Commission for sale in U.S. markets. Capital was raised directly from the private sector, from both individual and institutional investors. Notably, almost one in three American households today invest their savings and retirement funds in the U.S. securities markets, directly or through mutual funds.

At the same time, technological advances are changing the face of the marketplace itself. Investors are increasingly using electronic communications media to trade securities and obtain market information and advice. Likewise, the internationalization of the markets has spurred "round the clock" trading, as well as the development of new and complex financial products.

The dramatic growth of the U.S. securities markets presents new opportunities for businesses and investors—and new challenges for regulators and Congress. Together we need to determine how to keep the securities regulatory framework up to date; how to promote, rather than impede, market growth and development, while at the same time providing effective investor protection and supporting the investor confidence that plays so large a role in the success of our markets.

H.R. 2131 contributes some provocative ideas on this score. In so doing, the bill has prompted the Commission to take a new, hard look at the laws and assumptions under which we operate. Chairman Fields is to be commended for encouraging this reevaluation of federal securities regulation.

I. INTRODUCTION

The Commission's search for new ways to regulate more effectively and in a less burdensome way did not begin with H.R. 2131. The Commission has, on its own initiative, continually sought to "reinvent" itself: to streamline regulatory requirements, eliminate unnecessary burdens, and reduce bureaucracy, while at the same time providing effective investor protection. We have done this, moreover, with a modest staff and limited resources, operating in partnership with the securities industry and its self-regulatory organizations ("SROs").

To cite just a few highlights of the Commission's ongoing "reinvention" process, over the past two years, the Commission has undertaken to:

- *rationalize its own structure and operations* by (for example) recommending repeal of the 60-year old Public Utility Holding Company Act (a statute administered by the Commission); and revising and streamlining its rules governing adjudications and administrative proceedings;
- *promote capital formation* by streamlining and reducing various registration and disclosure requirements for companies that seek to access the securities markets;
- *simplify disclosure requirements* for corporate issuers and mutual funds, thus reducing compliance costs while offering investors more user-friendly information;
- *foster the international competitiveness of U.S. markets* through initiatives to facilitate foreign issuer access to U.S. securities markets;
- *promote market efficiency* by working with the Derivatives Policy Group to develop a voluntary framework for oversight of over-the-counter derivatives activities; and by implementing new rules and procedures to expedite Commission review of SRO rule proposals;
- *facilitate access to market information* by providing increased public access to its EDGAR filings through the Internet; and by reevaluating and updating its EDGAR system to take advantage of new technology; and

- *enhance investor protection* through continued, vigorous law enforcement; more efficient examinations of securities firms and investment advisers; and investor outreach efforts.

The Commission believes that these and other related efforts will do much to reduce regulatory burdens. We also recognize that still more can and should be done.

H.R. 2131 suggests new areas where further deregulation might serve the interests of competitive and efficient markets. The bill suggests a reevaluation of certain traditional aspects of the federal securities laws and contains in almost every provision suggestions that could result in productive change. Starting from that perspective, we hope today to engage in a vigorous and constructive dialogue regarding this bill, in a cooperative spirit, seeking ideas and input from all affected parties—corporate America, the securities industry, our fellow regulators, and most importantly, the investing public.

In analyzing and evaluating the provisions of H.R. 2131, the Commission has focused on the following basic questions: First and foremost, how will the change affect investor protection? Will the proposed reform foster capital formation and market efficiency? Will it represent a sound use of scarce government resources? And, finally, will the reform result in any unintended consequences?

It is with this focus that the Commission turns, below, to a discussion of H.R. 2131. We describe legislative concepts in the bill that we believe we can support; proposals that we believe may be better achieved through administrative rather than legislative action; and a few provisions of the bill that we simply disagree with. Additional (and more detailed) comments on the bill are set forth in the Appendix attached to this testimony.

As the legislative process moves forward, we hope to work closely with the Committee. We appreciate Chairman Fields' comment that this bill represents a "work in progress" and we appreciate this opportunity to participate in the process.

II. LEGISLATIVE CONCEPTS THAT THE COMMISSION SUPPORTS

A. Creation of National Securities Markets: Rethinking the Federal-State Regulatory Partnership

Section 3 of H.R. 2131 contains proposed amendments to the federal securities laws that would preempt most state requirements with respect to securities registration, broker-dealer registration and regulation, and the regulation of investment companies and investment advisers. Under the bill, the role of the states in these areas generally would be limited to: (1) requiring notice filings and collecting fees with respect to certain securities filings; (2) enforcing certain antifraud provisions; and (3) registering securities professionals through a centralized registration system, and collecting fees for such registration. The bill also would grant the Commission authority to exempt certain state requirements from preemption if the Commission finds that the public interest, the protection of investors, and the maintenance of fair and orderly markets would be served by state regulation.

Commission Recommendations. The current system of dual federal-state regulation is not the system that Congress—or the Commission—would design today if we were creating a new system. While securities markets today are global, U.S. securities firms still have to register securities personnel and certain securities offerings in 52 separate jurisdictions; to satisfy a multitude of separate books and records, qualification, and other requirements; to submit to the separate examination requirements of up to 52 different regulators; and to bear the substantial costs of compliance with these overlapping requirements.

At the same time, however, state securities authorities play an essential role in the regulation of the U.S. securities industry. State regulators are often the front line of defense against developing problems; they are the "local cops" on the beat who can quickly detect and respond to violations of law.

In short, this is an area where it is easier to identify the problem than to solve it. The issue is how to achieve a balance: how to retain the benefits of state regulation while reducing the burdens. The Commission believes that the best way to proceed would be to focus initial efforts on those areas where a consensus can be reached—specifically (as described below) in the investment company and investment adviser contexts. In addition, it is the Commission's view that state preemption is not generally appropriate in the enforcement context. Rather, the Commission believes that, while greater coordination among federal and state regulators on enforcement matters is desirable, this can be accomplished without legislation.

Investment Advisers. Today, there are approximately 22,000 investment advisers registered with the Commission. The ranks of registered investment advisers have increased by over 500 percent over the last decade, far outstripping the growth in the Commission's examination resources. As a result, smaller investment advisers

are now examined, on average, once every 44 years—which means that they are not examined at all.

There is clearly room—and a pressing need—for states to play an important role with respect to the regulation of investment advisers. The Commission has suggested, in fact, moving toward a system of "reverse preemption," under which state regulators would assume primary responsibility for examining advisers who manage assets under $5 million. Larger advisers, in turn, would remain registered with the Commission and would be relieved from state registration and regulation. Senator Gramm, sponsor of S. 148 (the "Investment Advisers Integrity Act"), proposed a similar approach earlier this year. The Commission has expressed its support for the concept contained in S. 148.

Investment Companies. Allocating federal and state responsibilities for the regulation of investment companies involves an entirely separate set of considerations. State regulation can pose particularly significant obstacles to investment companies, which typically engage in business on a national scale and are constantly in registration. Investment companies, moreover, are comprehensively regulated at the federal level under the substantive regulatory provisions of the Investment Company Act of 1940, in addition to the disclosure provisions of the Securities Act of 1933.

As a result, the Commission believes that state oversight of investment companies can be reduced without compromising investor protection.[1] Specifically, the Commission has proposed an approach under which a state could not prohibit any company registered under the Investment Company Act from selling securities in the state if the company satisfies certain requirements of federal law. Investment companies, however, would continue to file their documents with the states and pay the same fees as at present. The Commission would continue to seek input from state regulators in the course of SEC rulemakings with respect to investment companies. Finally, the states would continue to have a role in enforcing sales practice rules.

Securities Registration. The states have already taken important steps toward eliminating duplicative securities registration requirements by, for the most part, exempting from blue sky regulation companies that meet standards for exchange-listed and Nasdaq/National Market System securities. The Commission believes that it would be appropriate to codify standards comparable to these exemptions in federal law. Moreover, as a general matter, the Commission believes that the states should continue to receive copies of Commission filings, and should continue to collect fees at the current level. Certain categories of offerings (those that have been a source of frequent disclosure and sales practice abuses, such as limited partnerships, blank check and blind pool offerings, and penny stocks) should remain subject to both state and federal registration.

In addition, the Commission believes that there is room to modernize the exemption from federal registration for intrastate and certain other offerings. Just as states should defer to national offerings, so should the federal government defer to the states where local offerings are concerned. For other categories of offerings, several alternative options could be explored. One possible option would be to allow for an offering to be reviewed either at the federal level, or at the state level, at the issuer's option.

The Commission recommends that Congress, federal and state regulators, and industry participants work together to determine how best to reallocate responsibilities between the federal government and the states with respect to securities registration. The North American Securities Administrators Association ("NASAA") has already begun to address these issues with the formation of a blue-ribbon panel (of which Commissioner Wallman is a member) that will study and report on the relative roles of state and federal securities regulation. The panel's report is expected in early spring of 1996.

Broker-Dealers. The Commission recognizes that state regulators have a compelling interest in determining who may do business within their borders, and in how such business is conducted. The Commission also recognizes, however, that brokers and securities firms have a compelling interest in a centralized and predictable registration system.

Balancing these two concerns, the Commission believes that states should continue to license broker-dealers that do business within their respective jurisdictions (and to receive fees for licensing such broker-dealers). The Commission also believes

[1] At the same time, the Commission recognizes that state common and corporate laws generally govern the structure and operations of investment companies and should be preserved. Thus, a "blanket" preemption provision would not be appropriate. Any legislation must be carefully drafted to consider the interplay between, and purposes of, these differing regimes and the federal securities laws.

that states should continue to play a role in examining broker-dealers who operate within their jurisdictions. The states already have begun to take some steps to create greater uniformity by developing the central registration depository for broker-dealer registration.

At the same time, the Commission has also called on NASAA to work toward still greater uniformity and coordination among the states with respect to registration and disqualification criteria, and has endorsed efforts to explore reciprocal or national licensing arrangements. In response to the problem of duplicative, overlapping examinations, the Commission has proposed that state, federal, and SRO examiners work toward better scheduling, coordination and information-sharing. The Commission has already begun to work with the states and the SROs towards this goal, and intends to convene a regular "Planning Summit" where the Commission, the SROs, and the states would join together to discuss scheduling, priorities, and other examination issues.

The Commission also believes that states should not impose books and records and capital requirements that go beyond applicable federal and SRO standards. Instead, the states should come to the Commission with their concerns in these areas. Already, for example, Commission staff and representatives of NASAA have tentatively decided that either the National Association of Securities Dealers ("NASD") or the Commission could adopt amendments to its books and records rules addressing the concerns articulated by NASAA. Approaching books and records problems on a federal level, or through the NASD, will prevent any potential problems that may arise in the adoption of varying books and records rules by the states, ensuring uniformity in broker-dealer recordkeeping requirements. In either case, we expect to be able to address NASAA's concerns on an expedited basis.

B. Exemptive Authority

Section 7 of H.R. 2131 generally would amend the Securities Act to increase the Commission's authority to exempt offerings from the Act's registration requirements. Section 7(a) would raise the statutory limit for the exemption of small offerings to $15 million (thus expanding the Commission's discretionary rulemaking authority to exempt small offerings from registration under the Securities Act),[2] while Section 7(b) of the bill would provide the Commission with a grant of general exemptive authority under the Securities Act.

Commission Recommendation. Both the Investment Company Act of 1940 (section 6(c)) and the Investment Advisers Act of 1940 (section 206A) provide the Commission with broad grants of exemptive authority. The Commission supports the concept of a broad grant of general exemptive authority under both the Securities Act of 1933 and the Securities Exchange Act of 1934,[3] similar to the authority currently vested in the Commission under the two 1940 Acts. This type of exemptive authority would allow the Commission the flexibility to explore and adopt new approaches to registration, disclosure and related issues.[4]

Two far-reaching initiatives to develop such new approaches are already under way at the Commission. Last February, the Commission established an *Advisory Committee on the Capital Formation and Regulatory Processes ("Advisory Committee")* to consider comprehensive reforms of the registration and disclosure process. The Committee's mandate is broad in scope: it is considering, for example, whether Commission rules should permit a registration concept that relies more on *company* disclosure and market-driven securities and transaction disclosure ("company registration") rather than on the Commission's mandated transaction disclosure. This approach could streamline both registration and disclosure requirements, while ac-

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[2] The dollar ceiling for the small offering exemption contained in the Securities Act has been raised by Congress over the years; it started at $100,000 and was raised from $1.5 million to the current $5 million in 1980. In 1992, the Commission recommended legislation that would have increased the Commission's discretionary exemptive authority to $10 million.

[3] Notably, a number of provisions of the Exchange Act grant the Commission exemptive authority. For example, Section 12(h) of the Exchange Act currently provides the Commission with authority to exempt in whole or in part any issuer or class of issuers from the provisions of Sections 12(g), 13, 14 or 15(d) of that Act, as well as to provide exemptions from Section 16 of the Act.

[4] For instance, there has been a recent proliferation of electronic trading systems that do not fit neatly within the existing regulatory framework for exchanges and for which exchange registration may prove an unnecessary and undue regulatory burden. A grant of general exemptive authority under the Exchange Act would give the Commission the necessary flexibility to address appropriately the regulatory concerns that these entities may raise. Similarly, such a grant of authority would provide the Commission with flexibility to exclude certain classes of persons from regulation as brokers or dealers under circumstances in which the activities of such persons would not pose risks to the investing public.

tually enhancing information flow and protections to investors. The Commission expects to receive the Advisory Committee's recommendations early next year.

The Commission also recently established an internal *Task Force on Disclosure Simplification* ("Task Force") charged with reviewing all forms and all disclosure requirements imposed on public companies. The Task Force—whose outside advisor is Philip Howard, author of a book on regulatory simplification entitled *The Death of Common Sense*—is expected to make its recommendations to the Commission at the end of this year.

A grant of general exemptive authority could make it easier for the Commission to implement certain proposals that seek to assist small businesses with capital formation, such as the currently pending "test-the-waters" proposal. In addition, general exemptive authority could facilitate the implementation of "company registration" following the recommendations of the Commission's Advisory Committee (although it appears at this time that much of the company registration proposal could be implemented, albeit somewhat more awkwardly, under our existing rulemaking authority). In any event, a grant of general exemptive authority would make it unnecessary to give the Commission express authority to exempt any given class of securities (such as small offerings).[5]

C. Rules of Self Regulatory Organizations

Section 11 would require the Commission to publish notice of proposed self-regulatory organization ("SRO") rule changes within 30 days of the filing, unless the SRO consents to a longer period.

Commission Recommendation. The Commission supports the provision, which should further streamline the process for the approval of SRO-proposed rule changes. The provision would codify a practice that the Commission was committed to achieving on its own initiative.

D. Securities Margin Requirements

Section 4 would exempt from the margin provisions a broad range of "institutional" entities deemed to be "excluded accounts" (*e.g.*, certain corporations and employee benefit plans with assets exceeding $5 million, hedge funds, insurance companies, governmental entities, and certain financial institutions). The bill also would prohibit the exchanges and the NASD from imposing margin requirements that are in addition to, or inconsistent with, those of the Board of Governors of the Federal Reserve System ("Federal Reserve Board"). In addition, the bill would exempt "excluded accounts" from section 11(d) of the Exchange Act, which prohibits a broker-dealer from extending credit to customers on securities that it helped to distribute for 30 days after its participation in the distribution. The bill also would eliminate margin requirements for all debt securities.

Commission Recommendation. The Commission agrees that there is a need to reexamine margin requirements. This, however, is a complicated subject involving more than simply the amount of credit in the market. Other important issues include: continued investor confidence and participation in the markets, the solvency of financial institutions, the interplay of margin requirements with other financial responsibility rules (such as capital), competition concerns among various market participants, as well as potential systemic concerns. The Commission is concerned, however, that the approach proposed in H.R. 2131 does not appear to take all of these considerations into account.

The Commission, instead, has proposed a more limited alternative approach: codification of the agreement that was negotiated earlier this year between the Commission staff and three major securities firms (Goldman Sachs, Morgan Stanley, and Salomon Brothers).

If enacted, that agreement would: (1) eliminate federal margin treatment on most debt securities, while retaining federal margin requirements for debt securities that have been issued for less than 30 days; (2) exempt from federal margin requirements credit extensions by broker- dealers to broker-dealers that have a substantial public business or for the purposes of market- making or underwriting; and (3) give the Federal Reserve Board and the Commission the authority to exempt additional securities or transactions from the federal margin rules that each administers. Like H.R. 2131, the agreement also would repeal section 8(a) of the Exchange Act, which restricts the sources from which a broker-dealer may borrow to finance its securities operations.

[5] Thus, while the Commission supports raising the small offering "cap" (as proposed in section 7(a) of H.R. 2131), we believe that there may not be a need for section 7(a) if a general grant of exemptive authority (such as the one contemplated in the bill's section 7(b)) is provided to the Commission.

The Commission believes that this agreement would help resolve many of the industry's concerns regarding the ability of U.S. securities firms to obtain financing and to compete on a level playing field with banks and foreign entities. Moreover, the agreement would retain for the Federal Reserve Board, the SEC, the securities exchanges, and other SROs, the authority to establish appropriate margin provisions.

At the same time, further coordination among the various regulatory agencies is needed to fashion a more comprehensive approach to the margin issue, taking into account the broader margin-related issues discussed above. The Commission intends to pursue this issue through the Working Group on Financial Markets and other appropriate forums.

E. Prospectus Delivery

Section 6 of H.R. 2131 would: (1) amend existing law so that a confirmation of the sale of a security no longer constitutes a "prospectus" under the Securities Act; (2) require that a final prospectus accompany or precede a security offered for sale or a security being delivered after sale *only* if the purchaser or prospective purchaser has requested a prospectus; and (3) give the Commission authority to exempt from the Securities Act prospectus delivery requirements any person, prospectus, class of person or class of prospectus. Commission exemptive authority could be exercised by rule, regulation or order.

Commission Recommendation. The Commission agrees that the existing system does not serve either issuers or investors as well as we would like. As noted above, the Commission (through its Advisory Committee on Capital Formation and its Disclosure Task Force) has two major projects to evaluate the many complex issues related to prospectus content and delivery, the provision of information to investors in electronic form, and related topics. As a general matter, the Commission believes that these studies should be completed before significant legislative revisions to the prospectus delivery process are considered. In the interim, however, the Commission could support the section's grant of exemptive authority to the Commission, which would authorize the Commission to exempt certain offerings or issuers from prospectus delivery.[6]

As noted above, the Commission has undertaken a number of initiatives to improve the current system, while minimizing the regulatory costs and burdens imposed on issuers. For example, the Commission has undertaken steps to bring its prospectus delivery requirements into the electronic era: recently, the Commission issued an interpretive release providing guidance regarding the use of electronic media to communicate with investors under existing rules. The Commission also issued a release proposing technical amendments to its rules that are currently premised on the delivery of paper documents.

To some extent, Section 6 appears to be based on a concern regarding the complexity of many prospectuses. The Commission shares this concern and would like to make the prospectus more readable. The Commission has already begun this process, particularly in the area of encouraging "plain English" disclosures for mutual funds. The Commission already has worked with the mutual fund industry and state securities regulators to develop a fund "profile prospectus," the key element of which is a standardized, short-form summary of key fund features. The pilot "profiles" for eight mutual fund groups became available to investors last August.

F. Tender Offer Regulation

Section 5 of H.R. 2131 would amend the Exchange Act to repeal various provisions that govern tender offers: beneficial ownership rules, issuer tender offer and going private provisions, third party tender offer rules, reports on changes in majority of directors, and the imposition of transactional fees for changes in control. Congress enacted these provisions (collectively known as the Williams Act) in 1968 and amended them into their present form in 1970. The Williams Act is based on a principle of neutrality between bidder and target; its provisions focus on the protection of investors.

Commission Recommendation. The Commission believes that the Williams Act provisions have worked well and continue to work well, and therefore does not support the Act's repeal. However, we are open to considering appropriate modifications that may be suggested during the course of this Committee's hearings. In addition, the Commission can support (and has in the past supported) certain modifications to Exchange Act section 13(d) (a provision of the Williams Act which requires that

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[6] In any event, if the Commission is granted broad exemptive authority as proposed under Section 7 of this bill, it may not be necessary to include legislative provisions eliminating prospectus delivery; the Commission could use its exemptive authority in appropriate cases.

an acquiring shareholder provide information about itself and its intent with respect to its investment within 10 days of reaching a 5% ownership threshold.) The Commission believes that persons do not need 10 days to file this information, which is of dramatic significance to the marketplace. Two approaches could be considered: the 10-day period could be shortened; or the filing person could be required to file the information prior to any further purchases after reaching the 5% threshold. Either approach could enhance market efficiency.

G. Repeal of the Trust Indenture Act of 1939

Section 14 of H.R. 2131 would repeal the Trust Indenture Act of 1939 ("Act") on the grounds that market forces currently cause trust indentures to contain many more inclusive provisions than are mandated by the Act.

Commission Recommendation. The Trust Indenture Act was designed to protect investors in publicly offered debt securities by providing for an independent trustee to act on debtholders' behalf in the event of default and assuring certain minimum bondholder rights. Toward this end, the Act establishes obligations and standards for trustees and mandates that the bond indenture be governed by specified provisions in the Act. The Act was amended most recently in 1990, at the Commission's request, in order to provide the Commission with general exemptive authority to streamline the trustee conflict provisions, and to facilitate shelf registration.

The Commission would welcome input from industry participants about areas where the Act still does or does not work, and how it can be improved. If it appears that fundamental problems exist with respect to the Act's substantive investor protection provisions, the Commission would be willing to undertake a study (as it did with the Public Utility Holding Company Act) to evaluate the continued effectiveness of specific provisions of the Act, and to determine whether an outright repeal or fundamental revision of the Act would be appropriate.[7] Prior to completion of such a study, however, the Commission believes that it is not appropriate to recommend the outright repeal or fundamental revision of the Act.

III. CONCEPTS THAT THE COMMISSION BELIEVES MAY BE BETTER ACHIEVED THROUGH ADMINISTRATIVE ACTION

A. Designation of Primary SRO and Examining Authority

Section 12 of H.R. 2131 would require the Commission, after notice and comment, to designate one SRO as the examining authority for each broker-dealer. In addition to enforcing its own rules, the designated examining authority ("DEA") would be required to enforce the rules of any other SRO to which the broker-dealer belongs.

Commission Recommendation. The Commission agrees that duplicative and overlapping examinations impose unnecessary burdens on broker-dealers (and represent an inefficient use of regulatory resources). However, the Commission is concerned that, as drafted, Section 12 may have broad and unintended consequences for the Commission's ability to examine and oversee the activities of broker-dealers.[8]

In recent years, the Commission has placed new emphasis on coordinating examinations of broker-dealers and eliminating areas of duplication. For example, the Commission recently created an Office of Compliance Inspections and Examinations to coordinate better the agency's own examinations, and has begun working with the SROs in an effort to encourage cooperation among SROs in scheduling examinations. The Commission also intends to convene a "Planning Summit" as soon as possible where the Commission, the SROs, and the states will work toward better coordination in this area. These efforts will continue and should alleviate the chief concerns of market participants. Such efforts should make many, if not all, of the aspects of this provision unnecessary.

B. Promotion of Efficiency, Competition, and Capital Formation

Section 8 would require the Commission to consider or determine whether its actions will promote efficiency, competition, and capital formation whenever the Commission is required to consider or determine if that action is consistent with the public interest, the protection of investors, or both.

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[7] For example, the Commission would be willing to consider the merits of an approach that would permit an offering to be made without a trustee, provided certain conditions were met. Under this approach, a trustee would be appointed on the occurrence of certain "triggering" events only, with the substantive provisions of the conditions included in-the debt terms generally.

[8] This issue is discussed in greater detail in the Appendix to this testimony.

Commission Recommendation. The foremost mission of the Commission is investor protection. The Commission also strongly believes that efficiency, competition,[9] and capital formation concerns are elements of—and do not conflict with—the public interest and the protection of investors. Thus, in the Commission's view, existing law already requires the agency to give consideration to efficiency, competition, and capital formation concerns whenever the Commission is required to make a public interest determination.

The Commission recognizes, however, that H.R. 2131 seeks to establish a more formal mechanism for ensuring that these concerns are considered, and the Commission supports that underlying objective. At present, the Commission generally requires a cost/benefit analysis when it proposes or adopts its rules. The Commission is prepared to strengthen this requirement by requiring the staff to perform additional analysis of a rule's impact on competition, efficiency and capital formation. The Commission does not believe, however, that this analysis would be appropriate in the context of enforcement actions and adjudicated opinions. Thus, the Commission would oppose legislation that would mandate such an analysis in those contexts.

C. Treatment of Press Conferences

Section 13 of H.R. 2131 would exclude from the definitions of "offer" and "offer to buy" under the Securities Act press conferences, press releases and meetings between issuer press spokespersons and journalists associated with publications having a general circulation in the United States. It also would amend the definition of "prospectus" in section 2(10) of the Securities Act to exclude press releases made generally available to U.S. journalists (provided that the press release contains a statement to the effect that it is not an offer and that any public offering will be made only by a prospectus, and specifies the person from whom a prospectus may be obtained).

Commission Recommendation. Section 13 is apparently intended to eliminate perceived grounds for the exclusion of U.S. reporters from foreign press conferences regarding overseas offerings that are not available to U.S. investors (and, therefore, are not subject to U.S. registration and disclosure). Notably, the Commission and its staff have issued several statements in this area that were intended to assure market participants as to what is and is not required of them. The Commission has rulemaking authority to further address most of the concerns underpinning this provision. The staff of the Commission currently is developing rulemaking recommendations for the Commission to address concerns about access for U.S. journalists to offshore press conferences, interviews, and other news items.

The Commission is sympathetic to the concerns reflected in Section 13 of the bill and believes there is ample room under existing law to resolve these concerns. The Commission is concerned, however, that Section 13 as drafted may go well beyond its stated purpose. In particular, it effectively may allow, without limitation, written selling efforts outside the prospectus and registration statement—even in the case of registered offerings in the U.S.—as long as those communications are made through the press, or by press release. This would represent a fundamental change and warrants further study.

D. Privatization of EDGAR

Section 10 would direct the Commission to: (1) issue a request for proposals ("RFP") for a privatized EDGAR system that will provide for a "return to the government on its investment in the establishment of such system"; (2) ensure that the new system provides for rapid dissemination of filings; and (3) transmit to Congress the legislation required to implement the selected proposal. The process of preparing the solicitation, evaluating the proposals, making a selection and completing the legislative requirements would be completed within 180 days of enactment.

Commission Recommendation. The Commission recognizes the importance of EDGAR to the agency's mission and is committed to a fundamental reexamination of EDGAR and how it operates. Three months ago, for example, the Commission held a conference to obtain input from EDGAR users (filers, vendors, disseminators, analysts, investors, and others) on how to improve and update the EDGAR system. At the conference, Chairman Levitt noted: "In this world of instantaneous telecommunications, EDGAR has come to resemble the Pony Express. That is precisely

[9] Certain sections of the federal securities laws explicitly require consideration of competition (*e.g.*, Exchange Act sections 6(a)(8), 15A(b)(9), 17A(b)(3)(I), and 23(a)(2)). These sections generally require a finding that any burdens a Commission regulation or an SRO rule imposes on competition are necessary or appropriate in furtherance of the purposes of the Exchange Act.

why we have called for this conference. We want to rethink EDGAR from the ground up." The Commission has already begun, and is committed to, this process.

To follow up on some of the issues raised at the August conference, the Commission has asked the National Academy of Sciences Computer Science and Telecommunications Board to organize a panel of nationally-recognized computer industry experts to examine EDGAR. In particular, the Commission has asked the panel to offer ideas as to how the Commission should proceed with EDGAR to take advantage of the changing technological environment. In addition, the Commission has asked for advice regarding how the Commission should proceed with respect to existing private sector contracts, and whether further privatization of the system would be appropriate.[10]

The Commission is currently in the process of soliciting public comment, working with outside experts, and coordinating closely with interested Congressional staff, regarding improvements to the EDGAR system. The Commission believes that this process should be allowed to continue and, therefore, that a legislative solution is not needed at this time.

IV. AREAS THAT ARE NOT RIPE FOR LEGISLATION

A. Suitability Obligations

Under the federal securities laws, broker-dealers generally are responsible for making suitable recommendations, whether their clients are institutional or individual investors. Section 2 of H.R. 2131 would reverse this presumption with respect to "institutional clients" of broker- dealers: it would create a legislative standard that a broker-dealer is not liable for the investment decisions of such clients unless the parties have contracted to the contrary. The provision also appears to contemplate that, even where there is such a contractual agreement, the broker would have no duty to inquire into the financial needs and objectives of the customer. Section 2 would, moreover, define the term "institutional client" (i.e., all investors, other than natural persons, with $10 million or more in investments) in such a way as to include a wide variety of institutions with differing levels of sophistication and ability to make independent investment decisions, including municipalities that rely on local elected officials to make investment decisions. In so doing, Section 2 would deprive a large class of entities of important investor protections.[11]

Commission Recommendation. The Commission believes that the time is not now ripe for legislation in this area. The Commission only recently has published for public comment an NASD-proposed rule change that would provide, among other things, suitability guidelines for broker-dealers making recommendations to institutional customers. The NASD proposal generally would maintain the existing presumption that broker-dealers are responsible for making suitable recommendations, but would permit institutional parties to negotiate responsibility for investment decisions.

While the Commission has not taken a formal position with respect to the NASD proposal, the Commission favors an approach that would maintain the existing presumption that broker-dealers are responsible for making suitable recommendations to their institutional customers, while permitting flexibility, in appropriate circumstances, for parties to clarify the nature of their relationship. The Commission also believes that, if adopted, the NASD's proposed approach may resolve many of the concerns raised by market participants concerning their suitability obligations.[12] We therefore urge Congress to allow the rulemaking process to continue before enacting legislation in this area.

B. Reduction in Number of Members of Commission

Section 9 would reduce the number of members serving on the Commission from five to three, and would provide that no more than two commissioners may belong to the same political party. In order to implement the transition to a three-member

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[10] In that regard, the Commission notes that the concept of "privatization" raises a number of complex legal and practical issues, ranging from issues related to security and liability (*e.g.*, for the custody and accuracy of the corporate filings) to issues related to the recovery of private sector costs, fees, profits, and public access.

[11] Although Section 2 appears to be directed at SRO suitability standards, the creation of a legislative standard that would apply in all actions brought under the Exchange Act also could affect Commission actions brought under Rule 10b-5.

[12] Notably, the Government Finance Officers Association has filed a comment with the Commission generally supporting the NASD's approach, which recognizes that a suitability obligation is potentially applicable to any institutional customer, but raises a number of other concerns regarding the NASD's proposed rule. These and any other concerns will be considered by the Commission during the comment process.

Commission, the provision would abolish two terms of the Commission and extend the expiration dates of the three remaining terms. It would maintain the duration of terms at five years.

Commission Recommendation. The Commission supports retaining the current statutory make-up of the Commission, and therefore we oppose this provision. The Commission believes that the ability to confer as a larger, five member body has contributed greatly to the quality of the Commission's decision-making process.[13] Moreover, during the last several months (when there only have been two Commissioners at the agency), certain procedural issues have arisen, primarily with respect to complying with the provisions of the "Government in the Sunshine Act." With a three-member Commission, if the quorum were two members—or if there were any vacancy—there would be a recurrence of such issues.

CONCLUSION

The Commission is an agency that takes very seriously the directive to "reinvent" government. We have already begun to take important steps to reduce bureaucracy, streamline regulatory requirements, and eliminate regulatory burdens. We have done so throughout with the input of the industry we regulate, working in a public-private partnership.

H.R. 2131 raises additional areas where deregulatory initiatives may be appropriate. The Commission looks forward to working with the Subcommittee, as well as any other interested parties, on the many important issues raised by the bill. Working together, we can promote the continued success of our capital markets, into the next century and beyond.

APPENDIX A

CAPITAL MARKETS DEREGULATION AND LIBERALIZATION ACT OF 1995 (H.R2131)

Introduction. Chairman Fields introduced H.R. 2131, the "Capital Markets Deregulation and Liberalization Act of 1995" on July 27, 1995. Chairman Fields's stated intention is to "eliminate substantial amounts of duplicative regulation, lower the cost of capital to American business, and reduce compliance costs to business by billions of dollars." Toward those ends, H.R. 2131 would revise the existing laws governing, among other things: the responsibilities of broker-dealers to their institutional customers; the preemption of state securities regulation; margin requirements; the regulation of tender offers; securities registration and prospectus delivery requirements under the Securities Act; and the definition of the Commission's mission.

The Commission's comments with respect to each of H.R. 2131's provisions are set forth below, together with its recommendations regarding each provision.[1]

*   *   *

Section 2: Investment Recommendations to Institutional Clients

Section 2 creates a legislative presumption that a broker-dealer is not liable for the investment decisions of an institutional client (generally defined as other than a natural person having at least $10 million invested in securities in the aggregate in its portfolio), unless the parties have contracted to the contrary. The presumption would apply to all actions brought under "this title."

Comments—Suitability

• *Current Law.* Self-regulatory organization rules contain explicit suitability standards. In addition, as part of the obligation of fair dealing under self-regulatory organization rules, broker-dealers are required to have a reasonable basis for believing that their securities recommendations are suitable. The Commission and the courts have enforced the suitability doctrine through the application of the general antifraud provisions of the federal securities laws. The Commission has adopted explicit suitability requirements in certain of its rules, such as the rules applicable to transactions in penny stocks.

As a general matter, the existing presumption in the federal securities laws is that a broker-dealer is responsible for making suitable recommendations, regardless

[13] During its 60-year history, the Commission has had three or fewer members in office for a total of approximately *30 months,* and has had five members more than two-thirds of the time.

[1] On August 18, 1995, the Commission's staff provided the Subcommittee with technical comments on the provisions of H.R. 2131. The Commission's comments largely incorporate the staff's technical comments.

of whether the client is an institution or an individual investor. As part of its responsibility, the broker-dealer generally must inquire into the customer's financial needs and objectives, and must have a reasonable basis for recommending a particular security.

• *NASD Proposal.* The National Association of Securities Dealers, Inc. ("NASD"), after gathering and reacting to the comments of numerous respondents, including industry and institutions, has suggested an approach that would provide, among other things, suitability guidelines for broker-dealers making recommendations to their institutional customers. The NASD approach would allow its members to consider the differing levels of ability among institutions to evaluate investment risk and to make independent investment decisions. These guidelines include consideration of whether any understanding exists between the parties regarding the nature of the relationship and the services to be performed by the broker-dealer, and would allow the broker-dealer to take into account the expertise of particular institutions in making their own decisions.

• *Effect on Current Law.* H.R. 2131 would reverse the current presumption as to entities with at least $10 million in investments. Broker-dealers would be presumed not to be liable for unsuitable recommendations to institutional clients in the absence of a contractual agreement negating that presumption. The provision also appears to contemplate that, even where there is a contractual agreement in writing, the broker would have no duty to inquire into the financial needs and objectives of the customer. The provision would not appear to require the broker-dealer to disclose that it has no duty to make suitable recommendations unless it has entered into a contract with the customer.

Although the provision appears to be specifically directed at self-regulatory organization suitability standards, the creation of a legislative presumption that would apply in all actions brought under the Securities Exchange Act of 1934 ("Exchange Act") also could affect Commission actions brought under Rule 10b-5 of the Exchange Act.

• *Scope of Definition.* The term "institutional client," as defined in Section 2, is defined in such a way as to hinge solely upon the client's other security holdings, rather than also upon other factors that the Commission believes may be relevant to a suitability analysis. The current definition would include a wide variety of institutions with differing levels of sophistication and of ability to make independent investment decisions, including municipalities that rely on local elected officials to make investment decisions.

Notably, the $10 million threshold for determining institutional status does not (as some other statutes do) contain any exclusion for investments in such instruments as government securities (including investments in U.S. Treasuries) or the securities of registered investment companies.

Commission Recommendation—Suitability. The Commission believes that the time is not now ripe for legislation in this area. The Commission only recently published for public comment an NASD-proposed rule change that would provide, among other things, suitability guidelines for broker-dealers making recommendations to institutional customers. The NASD proposal generally would maintain the existing presumption that broker-dealers are responsible for making suitable recommendations, but would permit institutional parties to negotiate responsibility for investment decisions.

While the Commission has not taken a formal position with respect to the NASD proposal, the Commission favors an approach that would maintain the existing presumption that broker-dealers are responsible for making suitable recommendations to their institutional customers, while permitting flexibility, in appropriate circumstances, for parties to clarify the nature of their relationship. The Commission also believes that, if adopted, the NASD's proposed rule may resolve many of the concerns raised by market participants concerning their suitability obligations.[2] The Commission believes that this rulemaking process should be allowed to continue prior to legislation in this area.

Section 3: Creation of National Securities Markets

Section 3 contains proposed amendments to the federal securities laws that would preempt most state requirements with respect to securities registration, broker-dealer registration and regulation, and the regulation of investment companies and in-

[2] The Government Finance Officers Association has filed a comment with the Commission generally supporting the NASD's approach, which recognizes that a suitability obligation is potentially applicable to any institutional customer, but raises a number of other concerns regarding the NASD's proposed rules. These and any other concerns will be considered by the Commission during the comment process.

vestment advisers. Under the bill, the role of the states in these areas generally would be limited to: (1) requiring notice filings and collecting fees with respect to certain securities filings; (2) enforcing certain antifraud provisions; and (3) registering securities professionals through a centralized registration system, and collecting fees for such registration. The bill also would grant the Commission authority to exempt certain state requirements from preemption if the Commission finds that the public interest, the protection of investors, and the maintenance of fair and orderly markets would be served by state regulation.

Overview. The states play an essential role in the regulation of the U.S. securities industry. The states are particularly well-equipped to police violative conduct of a local nature, and this role should not be undermined. Nevertheless, carefully crafted federal legislation could reduce redundancies in regulation by the various states and create a greater uniformity of standards among the states. As part of this legislative process, Congress, federal and state securities regulators, and industry participants should work together to determine how best to allocate responsibilities between the states and the federal government. The Commission is pleased that the North American Securities Administrators Association ("NASAA") Conference has appointed a blue-ribbon panel (of which Commissioner Wallman is a member) to study and report on the relative roles of state and federal securities regulation. It is the Commission's understanding that the panel's report is expected in early spring of 1996.

As a general matter, the Commission believes that it would be preferable to focus initial efforts (legislative and otherwise) on those areas where a consensus can be reached—namely, in the investment company and investment adviser contexts.

Comments—Creation of National Securities Markets

Registration of Securities—Section 3(a)

• *Current Law.* The Securities Act of 1933 ("Securities Act") currently requires that securities offered or sold in interstate commerce either be registered with the Commission or be exempt from registration. Section 18 of the Securities Act expressly preserves state jurisdiction over any security or person. Most state securities laws likewise require that securities offered or sold in a particular state either be registered with the state or qualified under state law for an exemption from state registration requirements. In recent years, there has been progress toward elimination of duplicative state registration requirements. Almost all states exempt from their blue sky laws companies listed on the major exchanges or designated for trading on the National Market System of the NASDAQ. When state registration is required, many states do not limit their review of securities offerings to disclosure matters, but engage instead in "merit review," which allows them to review offerings for conflicts of interest and other substantive issues, such as the operating history of the company, and to block the sales of securities in their states. In addition, states may have different substantive registration and exemption standards and different procedures from each other.

• *Effect on Current Law.* Section 3(a) would preempt state regulation of most securities offerings, including those of mutual funds, that are registered with the Commission or qualify for exemption from federal registration. States would retain their current authority with respect to intrastate offerings and blank check offerings. Section 3(a) also would authorize the Commission, by rule or regulation, to exclude other securities from automatic preemption that are otherwise exempt from section 5 registration, thus making those other securities eligible for state regulation. States would retain the authority to require notice filings, consent to service of process, and fees with respect to many securities offerings.[3] States also would retain the ability to enforce their own antifraud laws (with respect to securities otherwise exempted under this section), so long as the conduct involved would violate the antifraud elements of section 17(a) of the Securities Act. The bill also makes clear that the states retain the authority to regulate securities that are not exempted under new section 18(a).

Section 3(a) also would amend the Securities Act to address the preemptive effects of the new provision in the context of federal-state cooperation, and authorize the Commission to cooperate with the states on securities matters that, in the Commission's judgment, could result in greater uniformity in federal-state regulation.

• *Effect on State Enforcement of Federal Securities Laws.* The opening statement for H.R. 2131 suggests that the states would be empowered to enforce the federal securities laws. While the bill can be read broadly to achieve this purpose, the bill

[3] The provision tracks the blue sky laws of most states in not permitting the state to require such notice filing, consent or fees in connection with securities listed or eligible for listing on the New York Stock Exchange, American Stock Exchange, or NASDAQ/NMS, or any securities of the same class or senior to such securities.

also can be read as simply preserving the authority of the states to enforce antifraud provisions of state law that are consistent with federal antifraud provisions.

If the bill is intended to provide that states may enforce the federal securities laws' antifraud provisions, many issues arise regarding the binding nature of state cases on the Commission. In addition, questions arise regarding what statute of limitations and what remedies would be available to the states. These questions might be addressed in the legislative history of the bill.

It also is not clear whether the states would be allowed to bring federal securities enforcement actions in state court. The federal courts now have exclusive jurisdiction over Commission enforcement actions.[4] This issue of federal/state court jurisdiction also may implicate the disparity concerning private actions that currently exists (as well as implicate, to a different extent, some of the issues raised just above). The Exchange Act provides for exclusive jurisdiction of the federal courts in all such private actions, see Exchange Act section 27, but the Securities Act and the Investment Company Act of 1940 ("Investment Company Act") both provide for concurrent state court jurisdiction over private suits. *See* Securities Act section 22(a); Investment Company Act section 44.

Commission Recommendation—Registration of Securities and Enforcement Issues. The Commission recognizes that federal and state regulators can work harder to better divide responsibilities in registering corporate securities. There are several approaches that could be considered, such as: codifying the existing exemptions from state regulation based on the standards underlying the exemptions for listed and NASDAQ/NMS securities, and modernizing the exemption from federal registration for intrastate and certain other offerings. No matter what approaches are chosen, states should continue to receive copies of Commission filings, and the current level of fees should be maintained.

Certain categories of offerings—those that have often been a source of disclosure and sales practice abuses, such as limited partnerships, blind pool and blank check offerings, and penny stocks—should remain subject to both state and federal registration. For the remaining categories of offerings, several alternative options could be explored. One possible option would be to allow for an offering to be regulated either at the federal level, or at the state level, at the issuer's option.

The Commission recommends that Congress, federal and state regulators, and industry participants work together to determine how best to reallocate responsibilities with respect to securities registration. We note that NASAA has already begun to address these issues with the formation of its blue-ribbon panel.

Finally, the Commission generally does not believe that state preemption is appropriate in the enforcement authority context; the Commission and the states need to work together to make the best use of limited enforcement resources, and this can be accomplished by greater coordination among federal and state regulators and without legislation.

Broker-Dealers—Section 3(b)

• *Current Law.* The federal securities laws generally prohibit brokers and dealers from effecting transactions in securities unless they register with the Commission and become a member of a self-regulatory organization. Pursuant to its authority under the Exchange Act, the Commission has adopted regulations concerning registration, capital requirements, books and records, and reporting obligations of such broker-dealers and their associated persons. States also impose their own registration and licensing requirements on broker-dealers and their associated persons. The states have taken steps to coordinate their processes, and to create greater uniformity among states through the use of the Central Registration Depository ("CRD"), a system to register broker-dealers. Some states impose supplemental requirements on broker-dealers, including different qualification and disqualification provisions, and different books and records and financial reporting requirements.

• *Effect on Current Law.* Section 3(b) of the bill would amend the Exchange Act to, among other things: (1) preclude the states from applying registration, licensing or qualification requirements to any broker-dealer, municipal securities dealer, or government securities broker-dealer who is registered with the Commission or has been exempted from such registration, as well as associated persons of the foregoing; (2) authorize the states to impose registration, licensing, or qualification procedures on broker-dealers as long as such procedures are performed through a central registration depository system and the state's substantive requirements are substantially similar to and not inconsistent with those required by the Commis-

[4] In contrast, Section 6(d) of the Commodity Exchange Act provides for state enforcement of the federal commodities laws, and permits such actions to be brought in state court. This enforcement authority includes injunctive actions, proceedings for other equitable relief, and damage suits.

sion; (3) prohibit the states from establishing broker-dealer capital, books and records, and reporting requirements that differ from those established by the Commission; (4) give the Commission exemptive authority to permit certain state regulation of broker-dealers that would otherwise be preempted upon a finding that such state regulation is in the public interest; (5) retain for the states the right to charge fees for broker-dealer registration, licensing and qualification that is otherwise in compliance with the new section; and (6) preserve, to the extent not preempted by the new section, the authority of the states to regulate, and bring actions against, broker-dealers pursuant to state law.

Commission Recommendation—Broker-Dealers. State regulators have a compelling interest in determining who may do business as a broker-dealer within their borders, and in how such business is conducted. The Commission also recognizes, however, that brokers and securities firms have a compelling interest in a centralized and predictable registration system.

The Commission believes that states should continue to license broker-dealers that do business within their respective jurisdictions. The Commission also believes that states should continue to play a role in examining broker-dealers who operate within their jurisdictions.

The Commission has called on NASAA to work toward still greater uniformity and coordination among the states with respect to registration and disqualification criteria, and has endorsed efforts to explore reciprocal or national licensing arrangements. In response to the problem of duplicative, overlapping examinations, the Commission has proposed that state, federal, and self-regulatory organization examiners work toward better scheduling, coordination and information-sharing. The Commission has already begun to work with the states and the self-regulatory organizations towards this goal, and intends to convene a regular "Planning Summit" where the Commission, the self-regulatory organizations, and the states would join together to discuss scheduling, priorities, and other examination issues.

The Commission also believes that the states should not impose books and records and capital requirements that go beyond applicable federal and self-regulatory organizations standards. Instead, the states should come to the Commission with their concerns in these areas.

Finally, the Commission believes that the states should continue to receive the same fees from broker-dealer licensing they receive currently.

Investment Companies—Section 3(c)

• *Current Law.* The federal securities laws comprehensively regulate the operations of investment companies, both under the Investment Company Act and the Securities Act. However, as a general matter, the Investment Company Act does not regulate all aspects of an investment company's structure. Rather, its provisions are superimposed with respect to select issues over a large body of state common and statutory law governing the operation of business entities and commercial transactions. State regulation of the activities of investment companies is based on state corporate law and state registration of securities offerings.

• *Effect on Current Law.* Section 3(c) would add language to the Investment Company Act to establish the Commission as having "the exclusive jurisdiction with respect to all securities and transactions" to which the Act applies, and to all persons to whom the Act applies.

• *Interaction with Section 3(a) of H.R. 2131.* As a practical matter, provisions in section 3(a) amending the Securities Act would preempt all state regulation of investment companies (as noted above, current state regulation of investment company activities is based on state registration of securities offerings). Section 3(c) appears to be intended to preclude the states from initiating investment company regulation through a means other than the regulation of investment company offerings.

• *Effect on Current State Law.* As noted above, the provisions of the Investment Company Act are superimposed to a large extent on state common and statutory law governing the operation of business entities and commercial transactions. The bill would appear to call into question a good deal of state law which the Investment Company Act assumes and upon which the current structure of investment companies depends, including state corporate, business trust, contract, uniform commercial laws, etc.

Commission Recommendation—Investment Companies. State regulation can pose particularly significant obstacles to investment companies, which typically engage in business on a national scale and are constantly in registration. Moreover, they are comprehensively regulated on the federal level by the Investment Company Act and the Securities Act and, therefore, the Commission believes that state oversight of investment companies can be reduced without compromising investor protection. However, as a general matter, state common and corporate laws govern the structure and operations of investment companies and, thus, any legislation must be

carefully drafted to consider the interplay between, and purposes of, these differing regulatory regimes and the federal securities laws.

One approach that could be considered would be to exempt investment companies from state merit or disclosure regulation, but to continue to require them to file documents with the states and to pay the same fees as at present. The Commission would continue to seek input from state regulators in the course of SEC rulemakings with respect to investment companies. Finally, the states would continue to have a role in enforcing sales practice rules.

Investment Advisers—Section 3(d)

• *Background.* There are approximately 22,000 investment advisers registered with the Commission. Forty-six states regulate advisers under similar statutes duplicating to some extent the provisions of the Investment Advisers Act of 1940 ("Advisers Act").

• *Effects on Current Law.* Section 3(d) would preempt state law with respect to the regulation of investment advisers. The Commission would be granted "exclusive jurisdiction with respect to all securities and transactions" to which the Advisers Act applies and to all persons to whom the Advisers Act applies.

• *Effect on Current State Law.* Under current law, the Advisers Act does not apply to securities or transactions, so that some of the language in proposed section 3(d) of H.R. 2131 may not be necessary. In addition, by giving the Commission exclusive jurisdiction over investment advisers, the bill may unintentionally preempt a number of state criminal and civil laws governing the actions of individuals and businesses, and may otherwise affect existing contractual relationships.

• *Resources.* Because of the large number of investment advisers registered with the Commission, there is a concern raised as to whether the Commission's current resources are adequate to have "exclusive jurisdiction" over federally registered investment advisers.

Commission Recommendation—Investment Advisers. As noted above, the number of investment advisers today exceeds 22,000, which is an increase of more than 500% in the last 10 years. Most of them are smaller advisers, who are examined infrequently, if ever. With respect to investment advisers, therefore, the Commission has suggested an approach whereby the states would assume primary responsibility for examining advisers with assets below $5 million. Larger advisers, in turn, would remain registered with the Commission and would be relieved from state registration and regulation. Senator Gramm, sponsor of S. 148 (the "Investment Advisers Integrity Act"), proposed a similar approach earlier this year. The Commission has expressed its support for the concept contained in S. 148.

Such an approach could be referred to as "reverse preemption," because the federal government would step aside and defer to the states who could do a more effective job in certain circumstances.

Section 4: Securities Margin Requirements

Section 4 would exempt from the margin provisions a broad range of "institutional" entities deemed to be "excluded accounts" (*e.g.*, certain corporations and employee benefit plans with assets exceeding $5 million, hedge funds, insurance companies, governmental entities, and certain financial institutions). The bill also would prohibit the exchanges and the NASD from imposing margin requirements that are in addition to, or inconsistent with, those provided for in the bill or those of the Board of Governors of the Federal Reserve System ("Board"). The bill also would remove the restrictions on arranging for the extension or maintenance of credit by others. In addition, the bill would exempt "excluded accounts" from section 11(d)(1) of the Exchange Act, which prohibits a broker-dealer from extending, maintaining, or arranging for the extension or maintenance of credit to customers on securities that it helped to distribute for 30 days after its participation in the distribution. Finally, the bill would eliminate margin requirements for all debt securities.

Comments—Margin Requirements

• *Current Law.* Exchange Act section 7(a) directs the Board to prescribe rules with respect to the amount of credit that may be initially extended and subsequently maintained on any nonexempted security; section 7(c) makes it unlawful for an exchange member, broker, or dealer, directly or indirectly to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer on any nonexempted security in contravention of the Board's rules. Pursuant to this authority, the Board adopted Regulation T, which sets forth margin requirements that apply to broker-dealers. Although the promulgation and interpretation of margin rules is the primary function of the Board, an exchange or NASD member also must comply with the maintenance margin requirements of the self-regulatory organizations of which it is a member.

• *Effect on Current Law.* Institutional customers falling within the definition of "excluded account" would be able to leverage their positions in the equity markets to the extent allowed by their broker-dealers. The exchanges and the NASD would not be able to craft their own additional margin requirements as they do now to protect their members or to respond to a market crisis.

• *Excess Leverage.* Margin requirements can help to prevent excessive leveraging by market participants and investors. The risk of firm defaults from excess levels of credit exposure would be greater for thinly capitalized entities.

• *Effect on Debt Securities Markets.* Because the bill eliminates the margin requirements for debt securities, it would appear to facilitate the development of when-issued and forward trading markets in debt securities, either of which could create potential problems that deserve further study.[5]

Commission Recommendation—Margin Requirements. The Commission agrees that there is a need to reexamine margin requirements. This, however, is a complicated subject involving more than simply the amount of credit in the market. Other important issues include: continued investor confidence and participation in the markets, the solvency of financial institutions, the interplay of margin requirements with other financial responsibility rules (such as capital), competition concerns among various market participants, as well as potential systemic concerns. The Commission is concerned, however, that the approach proposed in H.R. 2131 does not appear to take all of these considerations into account.

The Commission, instead, has proposed a more limited alternative approach: codification of the agreement that was negotiated earlier this year between the Commission staff and three major securities firms (Goldman Sachs, Morgan Stanley, and Salomon Brothers).

If enacted, the agreement would: (1) eliminate federal margin treatment on most debt securities, while retaining federal margin requirements for debt securities that have been issued for less than 30 days;[6] (2) exempt from federal margin requirements credit extensions by broker-dealers to broker-dealers that have a substantial public business or for the purposes of market-making or underwriting; and (3) give the Board and the Commission the authority to exempt additional securities or transactions from the federal margin rules that each administers. Like H.R. 2131, the agreement also would repeal section 8(a) of the Exchange Act, which restricts the sources from which a broker-dealer may borrow to finance its securities operations.

The Commission believes that this agreement would help resolve many of the industry's concerns regarding the ability of U.S. securities firms to obtain financing and to compete on a level playing field with banks and foreign entities. Moreover, the agreement would retain for the Federal Reserve Board, the SEC, the securities exchanges, and other self-regulatory organizations, the authority to establish appropriate margin provisions.

At the same time, further coordination among the various regulatory agencies is needed to fashion a more comprehensive approach to the margin issue, taking into account the broader margin-related issues discussed above. The Commission intends to pursue this issue through the Working Group and other appropriate forums.

Section 5: Minimizing Transaction Costs of Corporate Organizations (Tender Offer Regulation)

Section 5 would amend the Exchange Act to repeal various provisions devoted to tender offer regulation: beneficial ownership rules, issuer tender offer and going private provisions, third party tender offer rules, reports on changes in majority of directors, and the imposition of transactional fees for changes in control. Section 5 would not affect several other Exchange Act sections related to tender offers and devoted to: ownership reporting, antifraud provisions, and roll-up disclosure provisions. Further, tender offers involving the issuance of a security subject to Securities Act registration or a merger transaction subject to the proxy rules would remain subject to Commission regulations.

Comments—Tender Offer Regulation

• *Background.* Congress enacted sections 13(d) and (e) and 14(d)-(f) to the Exchange Act in 1968. These sections are collectively known as the "Williams Act," and they were amended into their present form in 1970. The Williams Act is based on

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[5] In a when-issued market, trading begins in the security before it is issued. When-issued and forward markets are similar to futures markets, but lack organized clearing mechanisms, exchange-type circuit breakers, and surveillance mechanisms such as position limits and audit trails.

[6] The self-regulatory organizations would retain margin authority for debt and equity securities.

a principle of neutrality between bidder and target;[7] its provisions are focused on the protection of investors.

Section 13(d) requires that a shareholder provide information about the acquiring shareholder and the shareholder's intent with respect to the investment within 10 days of reaching a 5% ownership threshold. This information provides the market with timely information about persons making accumulations of stock of a particular issuer.[8]

In addition, the regulatory scheme applicable to third party and issuer tender offers (sections 13(e) and 14(d)) provides target company shareholders with adequate time and information to make an informed decision as to whether to hold, tender or sell the securities subject to the tender offer and to assure equal treatment for investors.

• *Impact on Beneficial Ownership Reporting.* The bill would delete section 13(d) reporting. In essence, the proposed rescission of section 13(d) would cut back on the disclosure required. Disclosures deleted would include: (1) background of acquiring persons, (2) plans or proposals with respect to the company, (3) contracts and understandings with respect to any securities of the company, and (4) the source of funds for the acquisition.

H.R. 2131 would, however, retain the ownership reporting requirements under section 13(g). Exchange Act section 13(g) requires filing of a notice by a 5% shareholder that reports: (1) the shareholder's name, residency and citizenship; and (2) the number of shares in which the shareholder has an interest and the nature of that interest. Material changes in such information also are required to be filed. The timing and form of notice and amendments are left to Commission rulemaking. Currently, the Commission requires reporting under section 13(g) annually by persons exempt from Regulation 13D, such as institutions who acquire securities in the ordinary course of business and not with the purpose or intent of influencing control of the issuer of those securities.

Many of the rules promulgated under section 13(d) are also made applicable to section 13(g). Since section 13(g) would not be repealed, it is possible that the Commission could, in the future, require the information reported under section 13(g) to be filed other than on an annual basis. Nevertheless, unless the legislative history for this bill was clear on the point, it might not be evident what impact the deletion of section 13(d) and the rules promulgated thereunder would have on the substantive requirements of section 13(g) and the Commission's rulemaking authority under that section.

• *Impact on Issuer and Third Party Tender Offer Regulation.* The regulatory scheme applicable to third party and issuer tender offers is intended to provide target company shareholders with adequate time and information to make an informed decision as to whether to hold, tender or sell the securities subject to the tender offer and to assure equal treatment for investors.

Issuer and third party tender offers are regulated pursuant to Exchange Act sections 13(e) and 14(d), which would be deleted. Section 13(e) provides a general grant of rulemaking authority to the Commission to regulate issuer repurchases of securities either by: (1) defining acts and practices that are fraudulent, deceptive or manipulative; or (2) prescribing means reasonably designed to prevent fraudulent deceptions or manipulative acts or practices. The Commission has used this authority to impose on issuer tender offers largely the same regulation as imposed on third party tender offers pursuant to section 14(d).

Section 14(d) mandates that third party tender offers be conducted in accordance with such Commission rules as adopted under section 14(d). Section 14(d) specifies disclosures, withdrawal and prorationing rights, and that all tendering shareholders participate in bid increases. The Commission's exemptive authority under section 14(d) does not allow full flexibility to address cost and other issues.

However, H.R. 2131 does not repeal section 14(e). Section 14(e) is a fraud prohibition with respect to any tender offer, and authorizes the Commission to "define, and prescribe means reasonably designed to prevent such acts and practices, as are fraudulent, deceptive and manipulative." Such type of authority has been used in the past as the basis for substantive and disclosure based requirements. Section 14(e) also provides the clearest authority for the prohibition of insider trading in the context of tender offers.

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[7] The provisions are not designed to "tip[] the balance of regulation either in favor of management or in favor of the person making the takeover bid." S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967); H.R. Rep. No. 1711, 90th Cong., 2d Sess. 4 (1968).

[8] The section also requires disclosure of the source of funds for the acquisition as well as any arrangements the shareholder has with respect to other securities of the issuer.

Except to the extent the legislative history for this bill would otherwise provide, much of the regulatory scheme currently applicable to issuer or third party tender offers could arguably be imposed based on section 14(e) authority.[9] Assuming this is not the legislative intent, the rescission of sections 13(e) and 14(d) and the rules thereunder would cancel current provisions designed to provide for: (1) equal treatment of shareholders; (2) mandated disclosure regarding the material terms of the transaction; and (3) prohibition of first come-first served provisions that potentially have a "stampede" effect.

Notably, most friendly mergers are implemented not by means of tender offers but rather through a corporate merger or corporate acquisition. On a separate note, in contrast to the federal provisions, many state statutes to one degree or another provide protections for state-chartered corporations against hostile tender offers (the vast majority of state tender offer statutes restricting tender offers, for example, exclude friendly tender offers). As a result, many states have statutes that regulate unfriendly tender offers and share acquisitions in a substantive manner, and may otherwise increase the time and cost of the transactions. These state statutes have as their goal increasing investor protections. Moreover, and usually more costly than any of the federal or state statutory requirements, litigation brought in state court often adds to the time and cost of the transaction.

• *Deletion of Transactional Based Fee Requirement for Takeovers.* Exchange Act section 14(g) provides for the payment of fees to the Commission in connection with an acquisition, merger, consolidation or proposed sale or other disposition of substantially all the assets (regardless of whether that transaction is subject to the tender offer or proxy rules). H.R. 2131 would remove section 14(g) and would, therefore, reduce the fees that are deposited into the U.S. Treasury. This may result in budget "scoring" difficulties for H.R. 2131.

• *Impact on Going Private Regulations.* Section 13(e), discussed above, also serves as the basis for the Commission's "going private" disclosure scheme governing share repurchases by the company or its insiders that result in a company's going private. In these transactions, an issuer and/or its affiliate currently is required to disseminate to its shareholders and to file with the Commission a disclosure statement a certain period of time before the event addressing the transaction's fairness and any alternatives considered. Most management buyouts of the last 15 years have been subject to the Commission's going private rules.

The bill would delete the current requirements. However, to the extent that the transactions used to effect a going private transaction are subject to proxy regulation or the Commission's tender offer antifraud rulemaking authority under section 14(e), the existing disclosure mandates likely could be continued. Transactions that occur outside of these areas, however, such as squeeze out mergers or reverse stock splits, would no longer be subject to the going private disclosures.

• *Impact on Other Miscellaneous Corporate Control Provisions—Rules 13e-1 and 14f-1.* Under Rule 13e-1, a target company subject to a section 14(d) third party tender offer is required to file with the Commission and disseminate to shareholders certain disclosures before purchasing those shares subject to the tender offer. In addition, under Rule 14f-1, an issuer is required to file with the Commission and transmit to all holders of record certain disclosures prior to changing the composition of a majority of its board outside of a shareholder meeting. The required disclosure is equivalent to that provided to shareholders in a proxy statement.

By deleting section 13(e), the bill would also eliminate the requirement under Rule 13e-1 that a target company subject to a section 14(d) third party tender offer file with the Commission and disseminate to shareholders certain disclosures before purchasing those shares subject to the tender offer. By deleting section 14(f), the bill would also remove the requirement that an issuer file with the Commission and transmit to all holders of record certain disclosures prior to changing the composition of a majority of its board outside of a shareholder meeting.

Commission Recommendation—Tender Offer Regulation. The Commission is unaware of the class or constituency that supports the outright repeal or fundamental revision of these "Williams Act" provisions; in fact, the businesses most affected generally seem to be content with the Williams Act as a whole. Additionally, we do not believe that the states have sought exclusive jurisdiction in the tender offer area. The Commission believes that the Williams Act provisions have worked well and continue to work well, and the Commission does not support the Act's repeal. However, we are open to considering appropriate modifications that may be suggested during the course of this Committee's hearings.

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[9] In addition, tender offers involving the issuance of a security subject to Securities Act registration or a merger transaction subject to the proxy rules would remain subject to Commission regulations.

The Commission has in the past supported and would continue to support certain modifications to Exchange Act section 13(d).[10] The Commission believes that persons do not need 10 days to file the information required by that section, which is of dramatic significance to the marketplace. Two approaches could be considered: the 10-day period could be shortened; or the filing person could be required to file the information prior to any further purchases after reaching the 5% threshold. Either approach could enhance market efficiency.

Section 6: Prospectus Delivery

Section 6 of H.R. 2131 would: (1) delete from the definition of the term "prospectus" in Securities Act section 2(10) the phrase "or confirms the sale of any security" so that a confirmation of sale would no longer be a prospectus; (2) add the phrase ", if the purchaser or prospective purchaser of such security has requested a prospectus" at the end of section 5(b)(2) which requires that a final section 10(a) prospectus accompany or precede a security offered for sale or a security being delivered after sale; and (3) add a new section 5(d) that would give the Commission authority to exempt from section 5(b) any person, prospectus, class of person or class of prospectus. Commission exemptive authority could be exercised by rule, regulation or order.

Comments—Prospectus Delivery

• *Current Law.* Section 5 of the Securities Act prohibits any person from offering or selling a security through the use of interstate commerce or the mails unless a registration statement has been filed or is in effect, and provides that a prospectus which meets the requirements of section 10(a) of that Act (which governs the contents of a full statutory prospectus), filed as a part of the registration statement, be furnished to the purchaser prior to sale or with the confirmation of sale or, in some cases, at the time of delivery of the security after sale. Section 2 of the Securities Act defines a number of the technical terms used within section 5. The definition of prospectus in section 2(10) of the Act includes any written communication that "confirms the sale of any security" and, thus, a full prospectus must precede or accompany delivery of the security or the confirmation, whichever occurs first. After the effective date, sales literature in addition to the prospectus may be used, as long as the section 10(a) prospectus precedes or accompanies the sales literature.

• *Effect on Current Law.* The bill would amend the prospectus delivery requirements of the Securities Act in a number of respects. Section 6 of H.R. 2131 would amend the prospectus delivery requirements of the Securities Act to exclude sales confirmations from the definition of prospectus.

The bill would eliminate the requirement that a final prospectus accompany or precede a security for sale or a security being delivered after sale, absent a request by the purchaser or prospective purchaser. Because the bill would eliminate the prospectus delivery requirement of section 5(b)(2) absent a request by a purchaser or prospective purchaser, an offering of securities could be undertaken solely by oral representations, relying wholly on sales practices. However, the bill would not amend the prospectus delivery requirements of section 5(b)(1). Therefore, written offers generally could be made only through a section 10 prospectus—whether a preliminary prospectus or, in the case of mutual funds, a rule 482 "omitting prospectus" advertisement.

The bill would authorize the Commission to exempt from the statutory prospectus delivery requirements any person, prospectus, class of persons, or class of prospectuses. The bill would require the Commission to adopt rules and regulations setting forth the procedures to be followed in requesting an exemption. Any exemption granted would have to be "necessary or appropriate in the public interest and consistent with the protection of investors" and through the bill's provision section 8(b)) must "promote efficiency, competition, and capital formation." The Commission would have sole discretionary authority not to consider any application for an exemption, and the proposed provision would not require any notice or opportunity for hearing.

Notably, after effectiveness, the final section 10(a) prospectus still would have to be used in connection with sales literature and other offering material. During the "waiting period," written offers still would have to be made by means of a section 10 prospectus.

• *Mutual Fund Sales.* In effect, this provision would permit mutual fund shares to be sold without any delivery of a prospectus to the investor. Section 5(b)(1) would require written offers to be made by means of a section 10 prospectus. However, a

[10] As noted above, section 13(d) requires that a shareholder provide information (on Form 13D) about the acquiring shareholder and the shareholder's intent with respect to the investment within 10 days of reaching a 5% ownership threshold.

mutual fund is permitted to advertise using an "omitting prospectus" under Rule 482, which is specifically a section 10 prospectus for purposes of section 5(b)(1). Although Rule 482 ads cannot include an application for fund shares, it would be possible to include an "800" number that an investor could call to purchase fund shares. Because section 5(b)(2) would be amended so that it would no longer require delivery of the prospectus with the confirmation of a sale, an investor who called the "800" number and purchased fund shares would not receive a prospectus unless he or she specifically asked for one. Therefore, the bill would permit sales of mutual funds to be made without the investor receiving any written communication other than an "omitting prospectus" advertisement under Rule 482.

• *Press Releases.* Notably, while Section 6 of H.R. 2131 would not amend the definition of "prospectus" otherwise than with respect to confirmations, Section 13(b) of H.R. 2131 would amend section 2(10) of the Securities Act to deem press releases also not to be prospectuses.

Commission Recommendation—Prospectus Delivery. The Commission agrees that the existing system does not serve either issuers or investors as well as we would like. As noted below, the Commission is engaged in several comprehensive efforts to evaluate the many complex issues related to prospectus content and delivery, the provision of information to investors in other forms, and related topics. Most recently, the Commission issued an interpretive release providing guidance and a degree of certainty regarding the manner in which issuers and others may use electronic media to communicate with investors under current rules. The release discusses various ways to comply with existing delivery or transmission requirements using electronic means. The Commission also issued a release proposing technical amendments to its rules that are currently premised on the delivery of paper documents.

In addition, the Commission is taking fresh looks at the entire existing securities disclosure system.

Last February, the Commission established an *Advisory Committee on the Capital Formation and Regulatory Processes ("Advisory Committee")* to consider comprehensive reforms of the registration and disclosure process. The Advisory Committee's mandate is broad in scope: it is considering, for example, whether Commission rules should permit a registration concept that relies more on *company* disclosure and market-driven securities and transaction disclosure ("company registration") rather than on Commission's mandated transaction disclosure. This approach could streamline both registration and disclosure requirements, while actually enhancing information flow and protections to investors. The Commission expects to receive the Advisory Committee's recommendations early next year.

The Commission also recently established an internal *Task Force on Disclosure Simplification* ("Task Force") charged with reviewing *all* forms and *all* disclosure requirements imposed on public companies. The Task Force—whose outside advisor is Philip Howard, author of a book on regulatory simplification entitled *The Death of Common Sense*—is expected to make its recommendations at the end of this year.

The Commission also is in the process of trying to improve the usefulness of the information received by investors by encouraging, among other things, "plain English" disclosures for mutual funds. The Commission already has worked with the mutual fund industry and state securities regulators to develop a fund "profile prospectus," the key element of which is a standardized, short-form summary of key fund features. The pilot "profiles" for eight mutual fund groups became available to investors in August.

As a general matter, the Commission believes that the Advisory Committee and Task Force studies should be completed before significant legislative revisions to the prospectus delivery process are considered. In the interim, however, the Commission could support the section's grant of exemptive authority to the Commission, which would authorize the Commission to exempt certain offerings or issuers from prospectus delivery.[11]

Section 7: Exemptive Authority

Section 7 generally would amend the Securities Act to increase the Commission's authority to exempt offerings from the Act's registration requirements. Section 7(a) of H.R. 2131, the "small offering" exemption, would raise the statutory limit for the exemption of small offerings to $15 million, and thereby would expand the Commission's discretionary rulemaking authority to exempt small offerings from registration under the Act. Section 7(b) of H.R. 2131, the "general" exemption, would add

[11] In any event, if the Commission is granted broad exemptive authority as proposed under Section 7 of this bill, it may not be necessary to include legislative provisions eliminating prospectus delivery; the Commission could use its exemptive authority in appropriate cases.

section 3(d) to the Securities Act to provide the Commission with the authority to exempt any security or class of securities from that Act's registration requirements.

Comments—"Small Offering" Exemption (Section 7(a))

• *Current Law.* Section 3(b) of the Securities Act currently allows the Commission to exempt small offerings of up to $5 million.

• *History.* The dollar ceiling in section 3(b) has been raised by Congress over the years; it started at $100,000 and was raised from $1.5 million to the current $5 million in 1980. In 1992, the Commission proposed and adopted a set of major initiatives to streamline regulations affecting small businesses. As part of that process, the Commission acted upon its discretionary authority and expanded the small offering exemptions under the Act. The Commission also recommended legislation that would increase the Commission's discretionary exemptive authority under section 3(b) to $10 million. Several bills containing such a provision have been introduced in previous sessions of Congress, and the Commission testified in support of one of those bills.

• *State Regulation.* A question that may be raised relates to the ability of the states to regulate small business offerings falling within the scope of the exemption, and how this provision will interact with the state preemption provisions of this bill. Absent a specific Commission determination that state regulation is needed, the bill's preemption provisions (discussed above) would bar from regulation small offerings under the $15 million cap unless such offering qualifies for the intrastate exemption or is a blank check offering.

Comments—"General" Exemptive Authority (Section 7(b))

• *Current Law.* The Securities Act does not now provide for a grant of general exemptive authority to the Commission. Both the Investment Company Act (section 6(c)) and the Advisers Act (section 206A), provide the Commission with authority to exempt any persons, securities or transactions from any provision of the statute or the rules thereunder. Further, section 12(h) of the Exchange Act provides the Commission with the authority to exempt in whole or in part any issuer or class of issuers from the registration provisions of section 12(g) of that Act.

• *Effect of Provision.* The provision would add section 3(d) to the Securities Act to provide the Commission with the authority to exempt any security or class of securities from the Act's registration requirements. The bill's approach would appear to be more in line with the Exchange Act (section 12) model.

• *Certain Effects Unclear.* The summary statement indicates that the Commission would be given a general grant of authority to eliminate any rule or regulation that no longer serves a valid purpose; proposed Section 7(b) appears to be limited to registration requirements, although it is broadly drafted in that context. As a result, there may be debate as to the provision's application to other provisions of the Securities Act.

• *Case-by-Case Review.* Action "by order" would require the Commission to review and consider exemptive requests on a case-by-case basis.

• *Company Registration.* The Commission's Advisory Committee on Capital Formation and Regulatory Processes may recommend a "company registration" approach. A grant of general exemptive authority could help implement such a recommendation, as well as other Commission proposals (although much of the company registration proposal could be implemented, albeit somewhat more awkwardly, under the Commission's existing rulemaking authority).

• *Fees.* At present, fees collected for securities registered with the Commission fund a large portion of the Commission's budget. An agreement in principle has been reached in the House that would, among other things, decrease the Commission's reliance on fees to fund the agency's budget. However, if a large scale exemption from the registration requirements was adopted pursuant to the bill's provision, there could be an impact on fees collected by the Commission. It also should be noted that if company registration were to be implemented, the aggregate amount of fees paid to the Commission actually might increase because the number of securities issuances subject to registration and payment of fees would likely increase, although the timing on the receipt of fees may be somewhat delayed as compared to the current system.

Commission Recommendation—Exemptive Authority. The Commission supports the concept of a broad grant of general exemptive authority under the Securities Act, as well as under the Exchange Act,[12] similar to the authority currently vested

[12] Notably, a number of provisions of the Exchange Act grant the Commission exemptive authority. For example, section 12(h) of the Exchange Act currently provides the Commission with authority to exempt in whole or in part any issuer or class of issuers from the provisions of sections 12(g), 13, 14, or 15(d) of that Act, as well as to provide exemptions from section 16 of the Act. Similarly, a number of other provisions in the Exchange Act provide the Commission

in the Commission under the two 1940 Acts.[13] This type of exemptive authority would allow the Commission the flexibility to explore and adopt new approaches to registration, disclosure and related issues, such as some parts of the currently pending "test-the-waters" proposal under the Securities Act.[14]

While the Commission supports Section 7(a) of H.R. 2131 (which would raise the "small offering" ceiling), we do not believe that there is a need for the provision if a general grant of exemptive authority—such as the one provided for in H.R. 2131—is provided to the Commission.

Section 8: Promotion of Efficiency, Competition, and Capital Formation

Section 8 would require the Commission to consider or determine whether its actions will promote efficiency, competition, and capital formation whenever the Commission is required to consider or determine if that action is consistent with the public interest, the protection of investors, or both.

Comments—Promotion of Efficiency, Competition, and Capital Formation

• *Effect on Current Law.* The provision would require the Commission's separate consideration of these three factors whenever a public interest consideration or determination is made. In certain contexts, this may have unpredictable effects. For example, the Commission may be required to consider efficiency, competition and capital formation apart from, and to the same extent as, investor protection and other aspects of the public interest in determining applicable sanctions in enforcement cases.

Commission Recommendation—Promotion of Efficiency, Competition, and Capital Formation. The foremost mission of the Commission is investor protection. The Commission strongly believes that efficiency, competition,[15] and capital formation concerns are elements of—and do not conflict with—the public interest and the protection of investors. In other words, the Commission believes that it currently must give consideration to efficiency, competition, and capital formation concerns whenever the agency is required to make a public interest determination.

The Commission recognizes, however, that the provision seeks to establish a more formal mechanism for ensuring that these concerns are considered, and the Commission supports that underlying objective. At present, the Commission generally requires a cost/benefit analysis when it proposes or adopts its rules. The Commission is prepared to strengthen this requirement by requiring the staff to perform additional analysis of a rule's impact on competition, efficiency and capital formation. The Commission does not believe, however, that this analysis would be appropriate in the context of enforcement actions and adjudicated opinions. Thus, the Commission would oppose legislation that would mandate such an analysis in these contexts.

Section 9: Reduction in Number of Members of Commission

Section 9 would amend section 4 of the Exchange Act to reduce the number of members serving on the Commission from five to three, and would provide that no more than two commissioners may belong to the same political party. In order to implement the transition to a three-member Commission, the provision would abolish two terms of the Commission and extend the expiration dates of the remaining terms. It would maintain the duration of terms at five years.

Comments—Number of Commissioners

• *Effect on Current Law*

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with specific exemptive authority in defined circumstances, *see* sections 15(a)(2) and 17(h)(4) of the Exchange Act. *See also* section 3(a)(12) of the Exchange Act, which authorizes the Commission to define particular securities as "exempted securities" for purposes of the Exchange Act.

[13] Section 6(c) of the Investment Company Act, for example, covers all of the provisions of that Act (not just the registration requirements) and permits exemption by rule or regulation as well as by order.

[14] Further, there has been a recent proliferation of electronic trading systems that do not fit neatly within the existing regulatory framework for exchanges and for which exchange registration may prove an unnecessary and undue regulatory burden. A grant of general exemptive authority under the Exchange Act would give the Commission the necessary flexibility to address appropriately the regulatory concerns that these entities may raise. Similarly, such a grant of authority would provide the Commission with flexibility to exclude certain classes of persons from regulation as brokers or dealers under circumstances in which the activities of such persons would not pose risks to the investing public.

[15] Certain sections of the federal securities laws explicitly require consideration of competition (*e.g.*, Exchange Act sections 6(a)(8), 15A(b)(9), 17A(b)(3)(I), and 23(a)(2)). These sections generally require a finding that any burdens a Commission regulation or a self-regulatory organization rule imposes on competition are necessary or appropriate in furtherance of the purposes of the Exchange Act.

• *Staggering and Duration of Terms.* In regulatory commissions, the number of members often equals the number of years in a term. Thus, a five-member commission with five-year, staggered terms results in the expiration of one commission membership each year. The bill would abolish the two terms that expired in 1994 and 1995, and would extend the expiration dates of the terms expiring in 1996, 1997 (Commissioner Wallman), and 1998 (Chairman Levitt) to expire in 1999, 2001, and 2003, respectively.

This staggering of terms would result in an uneven distribution of expiration dates. The new five-year term that begins in 1999 would expire in 2004 (one year after the term that expired in 2003); the term that begins in 2001 would expire in 2006; and the term that begins in 2003 would expire in 2008. Thus, the pattern of expiration dates would be as follows: 2003, 2004, 2006, 2008, 2009, 2011, 2013, 2014, etc. Two terms on the Commission would therefore expire one year apart, while the other term would expire two years before and after the other two terms.[16]

• *Sunshine Act and Quorum.* The effect of the provision on the Commission's administration of the Government in the Sunshine Act would depend on the quorum rule under the new law. If the Commission continues to require three members for a quorum when three are in office and not recused, the provision would appear to have no impact on the Commission's operations. If, however, the Commission (or Congress) were to provide that two out of three constitute a quorum (as would be expected with a three-person Commission), then the Sunshine Act results could seriously impair discussions between any two Commissioners. If two out of three commissioners were to constitute a quorum as to all matters, then discussions between any two commissioners would probably constitute a "meeting" under the Sunshine Act, which would require advance notice and opportunity for public attendance at such meetings unless the meeting satisfies certain exemptive criteria.

• *Other Effects.* During almost all of the Commission's existence, four or five members have been in office, and the ability to confer as a five-member collegial governing body has contributed greatly to the quality of the agency's decision-making process. Further, a five-member Commission enables members to pursue initiatives that other members or Commission staff do not have time or resources to pursue. In recent years, when the Commission has generally had four or five members in office, commissioners have focused on such issues as: the regulation of municipal securities, the regulation of derivatives markets, the regulation of public-utility holding companies, and administrative proceedings before the Commission.

• *Savings.* The provision is premised in part on the assumption that it costs the federal government $1 million each year to employ each commissioner (including staff) other than the chairman. The Commission's Office of the Comptroller estimates, however, that it costs the federal government roughly $480,000 a year for the employment of each commissioner, including the proportionate reduction of relatively fixed costs such as office space rental and other overhead (such as utilities). The aggregate savings from reducing the Commission from five members to three members would be close to, but less than, $1 million per year.

Commission Recommendation—Number of Commissioners. The Commission supports retaining the current statutory make-up of the Commission, and therefore we oppose this provision. The Commission believes that the ability to confer as a larger, five member body has contributed greatly to the quality of the Commission's decision-making process.[17] Moreover, during the last several months (when there only have been two Commissioners at the agency), certain procedural issues have arisen, primarily with respect to complying with the provisions of the "Government in the Sunshine Act." With a three-member Commission, if the quorum were two or if there was any vacancy, there would be a recurrence of such issues.

Section 10: Privatization of EDGAR

Section 10 would direct the Commission to: (1) issue a request for proposals ("RFP") for a privatized EDGAR system that will provide for a "return to the government on its investment in the establishment of such system"; (2) ensure that the new system provides for rapid dissemination of filings; and (3) transmit to Congress the legislation required to implement the selected proposal. The process of preparing the solicitation, evaluating the proposals, making a selection and completing the legislative requirements would be completed within 180 days of enactment.

Comments—EDGAR

[16] To resolve this uneven pattern, terms could be lengthened from five to six years, with expiration every two years (as with the U.S. Senate), or could be shortened from five to three years, with expiration every year.

[17] During its 60-year history, the Commission has had three or fewer members in office for a total of approximately *30 months*, and has had five members more than two-thirds of the time.

• *Current Law.* Exchange Act section 35A mandates the requirements for the EDGAR system. The system is designed to accelerate the processing, dissemination, and analysis of time-sensitive information filed with the Commission. The system is intended to automate the receipt, processing, and dissemination of documents filed with the Commission and to provide comprehensive automation capabilities for the full disclosure activities of the Commission.

• *Background.* At least part of the EDGAR system already is privatized: a private firm operates the system, and another private firm is responsible for the dissemination subsystem. The system is almost fully implemented, with the final "phase-in" period for filers scheduled to occur in May 1996. The Commission's contract with the current EDGAR vendor is due to expire in 1997; the current schedule calls for a vendor to be selected in October 1996. The staff currently is reexamining certain technical and other aspects of the system, while also preparing an RFP for release in December 1995 or early 1996.[18]

• *Effect on Current Law/Current Operations.*

• *"Return to the Government."* The provision contains the conditional language "return to the government on its investment in the establishment of such system." The Commission is unclear as to the precise intention of that language, and requests clarification. While the language appears to contemplate more than just "privatizing" EDGAR, it also appears to call for some (or all) of the existing investment in EDGAR to be recovered. If that is the case, the new vendor's costs will include not only the cost of its system, as proposed, but also a "premium" payment to the government for the privilege of being the system operator.[19]

• *Bidding Process.* A potential, unintended consequence of the provision could be to introduce uncertainty into the current bidding process, as potential bidders would have to consider whether the historical costs of the system would have to be recovered by the government. This would be especially problematic if the provision was enacted after a bidder's proposal was selected. Some vendors may choose not to bid in the face of such uncertainty or may bid in ways that would not meet Congress' intent and expectations. Such uncertainty, among other things, may make it difficult for the Commission to comply with the timetable imposed by the bill and the Commission's current schedule.

• *Other.* The Commission notes that the provision would provide the agency with substantial system capabilities which are not financed through the traditional appropriations process.

• *Commission Staff Functions.* One variable in the proposed privatization model is the extent to which Commission staff functions should or should not be included. The bill appears to suggest that, since the Commission is issuing an RFP and selecting a vendor, the Commission's own needs should be included. Document costs increase, of course, as the cost of meeting Commission staff requirements increases.

Commission Recommendation—EDGAR. The Commission welcomes continued Congressional oversight in this area. The Commission recognizes the importance of EDGAR to the agency's mission and is committed to a fundamental reexamination of EDGAR and how it operates. The Commission is in the process of soliciting public comment, working with outside experts, and coordinating closely with interested Congressional staff, regarding improvements to the EDGAR system. The Commission believes that this process should be allowed to continue and, therefore, that a legislative solution is not needed at this time.

Section 11: Rules of Self Regulatory Organizations

Section 11 would require the Commission to publish notice of proposed self-regulatory organization ("SRO") rule changes within 30 days of the filing, unless the SRO consents to a longer period.[20]

Comments—Rules of Self-Regulatory Organizations

• *Current Law.* Exchange Act section 19(b) requires SROs to file with the Commission all proposed rule changes. These filings must be accompanied by a concise general statement of the basis for and purpose of the proposed rule change. The sec-

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[18] A conference was held August 14, 1995, to initiate the Commission's dialogue with various "users" of an electronic disclosure system: filers, vendors, disseminators, analysts, investors, and other securities industry practitioners.

To follow up on some of the issues raised at the August conference, the Commission has asked the National Academy of Sciences Computer Science and Telecommunications Board to organize a panel that will examine EDGAR. The panel will consist of nationally recognized computer industry experts.

[19] We reach this conclusion because it appears that it is this "premium" which satisfies the provision's condition.

[20] The summary to the bill specifies a 90-day time period between receipt of a proposed rule change and its publication, rather than the 30 days provided in the text.

tion also requires the Commission, after the filing of a proposed rule change, to publish notice of the proposed rule change so that the public may submit written comments, but does not expressly impose a time period as to how quickly the Commission must file notice in response to the SRO's filing.

• *Background.* In its January 1994 Market 2000 Study, the Division of Market Regulation reasserted its continued commitment to work with the SROs to streamline the process for the approval of proposed rule changes. As part of this ongoing process, the Division has endeavored to reduce the period between filing and notice of SRO rule changes. That period has steadily declined since the beginning of 1994. During the first four months of 1994, 41% of the 156 rule changes filed were noticed within 30 days. In the first six months of 1995, 57% of the 260 rule changes filed were noticed within 30 days. In addition, the Commission recently eliminated the need for the agency's prior review of certain SRO rule filings.

• *Effect on Current Law/Practice.* The provision would not appear to alter the scope of Commission review as currently provided for in the Exchange Act, but would reinforce current practice that the Commission process SRO-proposed rule changes expeditiously.

Commission Recommendation—Rules of Self-Regulatory Organizations. The Commission supports the provision, which should further streamline the process for the approval of SRO-proposed rule changes. The provision would codify a practice that the agency was committed to achieving by its own initiative.

Section 12: Designation of Primary SRO and Examining Authority

Section 12 of the bill would require the Commission, after notice and comment, to designate one SRO as the examining authority for each broker-dealer. In addition to enforcing its own rules, the designated examining authority ("DEA") would be required to enforce the rules of any other SRO to which the broker-dealer belongs.

Comments—Designation of Primary SRO and Examining Authority

• *Current Law.* Section 17(d)(1) of the Exchange Act currently authorizes the Commission to allocate SRO examinations, and provides sufficient authority for the Commission to require SROs to eliminate any duplication with respect to the functions examined. Section 17(d)(1) also provides factors to consider in making such allocations, such as duplication of effort, cost, availability of staff, and protection of investors.

Under the existing rulemaking authority under this section, the Commission has adopted two rules.[21] The first, Rule 17d-1, requires the Commission to allocate the financial examination function to one DEA, if the broker-dealer is a member of more than one SRO. In practice, one DEA is selected for each broker-dealer based on factors listed in the rule. The second, Rule 17d-2 provides procedures for SROs to allocate between themselves the responsibility to examine members for compliance with SRO and Commission rules. In general, the SROs allocate sales practice and other compliance examinations among themselves.

• *Effect on Current Law.* Although the allocation of SRO examinations is addressed under section 17 of the Exchange Act, the proposed amendment would be added to section 15 of the Act. The bill could be read to result in the unintended consequence of leaving the Commission with no examination or oversight authority for broker-dealers (other than in enforcement actions). In addition, although the provision is designed to consolidate examinations of broker-dealers that are members of multiple SROs, it does not appear to give the DEA examination and oversight authority with respect to the federal securities laws. Moreover, the provision appears to be inconsistent with current section 19(g), which requires SROs to enforce compliance with their rules, and creates uncertainty as to whether sections 17(b) and (d) of the Exchange Act are intended to be supplemented or replaced.

• *Forum Shopping.* Differing standards of enforcement between DEAs could create competitive inequities. "Forum shopping" concerns could arise as the provision would require the Commission to grant broker-dealer requests to change DEAs under certain circumstances. The notice and comment provision regarding the designation of each broker-dealer's DEA could raise somewhat different, but related, concerns.

• *Objectives.* Investor protection and the efficient allocation of SRO resources are objectives of the current law under Exchange Act section 17(d)(1) (discussed above). To the extent that the provision emphasizes minimization of costs to broker-dealers of the examination and oversight process, it could be perceived as lessening the importance of those current objectives.

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[21] The Commission could use its existing authority to require the SROs to eliminate duplication with respect to the functions they examine.

• *SRO Rulemaking Function Split from Enforcement/ Surveillance Function.* The provision would require the DEA to enforce other SROs' rules. While an SRO has considerable incentive to enforce its own rules, its incentive to enforce the rules of other SROs may not be as strong. For example, one exchange's rules with respect to market manipulation are critical to that exchange's operation and reputation, but another exchange might have less incentive to make the enforcement of such rules a priority.

Currently, SROs monitor trading activities on their own exchanges. The bill, however, appears to require the DEA to monitor trading on all SROs. This could be costly to the SROs, and could be significantly less effective than the current system.

• *NASD Role.* The NASD currently takes responsibility for sales practices in several areas, including corporate underwriting, limited partnerships, municipal securities, government securities, and mutual funds. It is not clear whether such centralized administration would continue under the bill.

Commission Recommendation—Designation of Primary SRO and Examining Authority. Duplicative and overlapping examinations impose unnecessary burdens on broker-dealers (and represent an inefficient use of regulatory resources). Accordingly, in recent years, the Commission has placed new emphasis on coordinating examinations of broker-dealers and eliminating areas of duplication.

For example, the Commission recently created an Office of Compliance Inspections and Examinations to coordinate better the agency's own examinations, and has begun working with the SROs in an effort to encourage cooperation among SROs in scheduling examinations. The Commission also intends to convene a regular "Planning Summit" where the Commission, the SROs, as well as the states will work towards, among other things, better coordination in this area. These efforts will continue and should alleviate the chief concerns of market participants. Such efforts should make many, if not all, of the aspects of this provision unnecessary.

The Commission believes that these initiatives may be preferable to legislation at this time. Moreover, as indicated above, the Commission believes that several aspects of the provision may have broad and unintended consequences for the Commission's own examination and oversight authority with respect to broker-dealers.

Section 13: Treatment of Press Conferences

Section 13 of the bill would amend the definition of "offer" and "offer to buy" to exclude press conferences, press releases and meetings between issuer press spokespersons and journalists associated with publications having a general circulation in the United States. It also would amend the definition of "prospectus" in section 2(10) of the Securities Act to exclude press releases made generally available to U.S. journalists (provided that the press release contains a statement to the effect that it is not an offer and that any public offering will be made only by a prospectus, and specifies the person from whom a prospectus may be obtained). These provisions are intended to eliminate perceived grounds for the exclusion of U.S. reporters from foreign press conferences regarding overseas offerings that are not available to U.S. investors (and, therefore, are not subject to U.S. registration and disclosure).

Comments—Treatment of Press Conferences

• *Current Law.* U.S. securities laws do not require that U.S. press be excluded from foreign issuers' press conferences, meetings, or other press coverage concerning offshore offerings by foreign companies. The Commission already has taken a number of actions under its existing rulemaking authority to address the problems of U.S. press access to information about foreign companies' offerings, including a specific provision in Regulation S which states such contacts do not raise Securities Act registration concerns under certain circumstances. Regulation S, which provides that no registration under the Securities Act is required for offshore offerings, specifically states that:

> Nothing in these rules precludes access by journalists for publications with a general circulation in the United States to offshore press conferences, press releases and meetings with company press spokespersons in which an offshore offering or tender offer is discussed, provided that the information is made available to the foreign and United States press generally and is not intended to induce purchases of securities by persons in the United States or tenders of securities by United States holders in the case of exchange offers.

• *Effect on Current Law.* The legislation would exclude from the definition of offer to sell, and from the definition of prospectus, contacts with the press, even if made by a domestic company with respect to an offering to U.S. investors, and with the purpose of inducing U.S. persons to invest. By removing press releases from the definition of prospectus, misleading information disseminated through press releases would not be subject to section 12(2) liability.

While the stated purpose of the provision is to allow U.S. press equal access to information concerning foreign issuers and their offerings, the provisions appear to go well beyond that purpose. The provisions appear to deregulate communications by all issuers—foreign and domestic—as long as they are made through the press, or by press release, even if the communications are made during the course of a U.S. offering for the purpose of conditioning the market for the securities in the U.S. Issuers would appear to have free writing ability through press releases, since press releases with the cautionary "not an offer" language would not be offers or prospectuses.

• *Concerns of Foreign Issuers.* Notwithstanding the Commission's past statements in this area, it may be possible that foreign issuers continue to have concerns about their ability to demonstrate that a communication was not made for the purpose of inducing purchases in the U.S. As noted above, the Commission has rulemaking authority to address these and other concerns.

Commission Recommendation—Treatment of Press Conferences. As noted above, this provision is apparently intended to eliminate perceived grounds for the exclusion of U.S. reporters from foreign press conferences regarding overseas offerings that are not available to U.S. investors. Notably, the Commission and its staff have issued several statements in this area that were intended to assure market participants as to what is and is not required of them. The Commission has rulemaking authority to further address most of the concerns underpinning this provision. The staff of the Commission currently is developing rulemaking recommendations for the Commission to address concerns about access for U.S. journalists to offshore press conferences, interviews, and other news items.

The Commission thus believes—although it is sympathetic to the concerns reflected in the provision—there is ample room under existing law to resolve these concerns. Moreover, as noted above, the Commission is concerned that the provision as drafted may have certain unintended consequences.

Section 14: Repeal of the Trust Indenture Act of 1939

Section 14 would repeal the Trust Indenture Act of 1939 ("Act") on the grounds that market forces currently cause trust indentures to contain many more inclusive provisions than are mandated by the Act.

Comments—Repeal of Trust Indenture Act of 1939

• *Current Law.* The Act's purpose is to protect investors in publicly offered debt securities by providing for an independent trustee to act on debtholders' behalf in the event of default. The statute itself discusses the adverse effects upon public debt holders when they are not able to take concerted action through an independent trustee acting on their behalf, when the trustee's responsibilities and standard of conduct are not specified, or when the trustee is not entitled to a report of the financial condition of the issuer.[22]

The Act mandates various protections for debtholders including the obligations and standards for the trustee. Minimum debtholders' rights, such as the right not to have principal and interest payments (subject to specific exception) waived without the holder's consent also are mandated. Generally, the form of indenture is filed as an exhibit to the registration statement and a statement regarding the eligibility of the trustee is filed as part of the registration statement. The financial terms of the debt, including restrictive covenants and events of default, generally are not regulated by the Act. As such, the Act does not impose any limitation upon the type of debt securities which may be offered or the terms thereof.

Among the more significant indenture provisions required for every indenture subject to the Act are those that: require an independent trustee to represent the debt holders (specified trustee conflicts of interest prohibited); specify high standards of trustee conduct (duties and responsibilities imposed on trustee both prior to and in case of default); provide a structure through which debt holders can protect their interests in the event of default on either an indenture covenant or payment of principal or interest; and provide procedural and substantive protections against inappropriate removal of collateral underlying secured bonds.

• *Background.* In 1990, the Act was amended at the Commission's request to provide the Commission with general exemptive authority, to streamline the trustee conflict provisions and to facilitate shelf registration. The 1990 Amendments required provisions which are automatically included in the indenture, reducing the cost of drafting provisions which satisfy the statute. Similarly, as amended, the Act permits the naming of the trustee to be delayed in shelf offerings until the securities

[22] The Congressional hearings that led to the adoption of the Act described the significant abuses resulting from the ability of an issuer to replace the collateral for secured obligations with substitute collateral that may be of substantially lesser value.

are issued (this removes the most significant cost resulting from the Act—maintenance of an independent trustee—until debt securities actually are outstanding). Recent amendments also significantly revised the "independent trustee" requirement to permit consideration of independence only at the time of an event of default, thus permitting a bank to be the trustee with respect to debt securities issued by persons with whom the bank has an on-going relationship.

• *Effect of Provision on Current Practices.* The Act would be repealed. The market may or may not continue to include provisions that equate or expand upon the Act's required provisions. It also is possible that while the market may require the inclusion of provisions which provide protections for certain business events (e.g., "event risk covenants" that give debt holders enhanced rights upon certain adverse financial results), other Act-required protections may not be included.

It is not certain that all costs related to the Act will decrease if these requirements are repealed; certain costs may increase for companies if the various rights of debtholders currently mandated by the Act are different (and have to be negotiated, and possibly disclosed) in each offering.

Commission Recommendation—Repeal of Trust Indenture Act of 1939. The Commission would welcome input from industry participants about areas where the Act does or does not work, and how it can be improved. If it appears that fundamental problems exist with respect to the Act's substantive investor protection provisions, the Commission would be willing to undertake a study (as it did with the Public Utility Holding Company Act) to evaluate the continued effectiveness of specific provisions of the Act, and to determine whether an outright repeal or fundamental revision of the Act would be appropriate.[23] Prior to completion of such a study, however, the Commission believes that it is not appropriate to recommend the outright repeal or fundamental revision of the Act.

Mr. FIELDS. Thank you, Mr. Chairman. We appreciate the tenor of your remarks. We also appreciate the fact that you are willing and have engaged in a dialog with all parties, not just people on the Hill but people involved in the industry, people who regulate in other venues.

Let me start by asking, you recently stated, in a speech before a group of State regulators, that "There is," and I quote, "no defense for duplication. There is no defense for waste. There is no defense for needless burdens on legitimate businesses."

Just a general question. How does the current overlapping Federal-state regulatory system create unnecessary waste and duplication?

Mr. LEVITT. Well, I guess I go back to my experience in running a brokerage firm and running an SRO. To the extent to which one has to coordinate, to the extent to which there is overlapping responsibility in terms of regulatory matters, it creates a certain amount of redundancy, time delays, a certain amount of confusion, and a great deal of cost.

On the other hand, the protection of investors is not a simple matter, and it's not anything that any one element in this very complex process can do by itself. We rely extensively on a combination of Commission efforts, private rights of action, SROs, and in a number of cases, on State regulators to work with us to eliminate the kind of fraud and malfeasance that is injurious to our markets.

But clearly when there is lack of clarity, lack of specificity in terms of regulatory authority, it does create problems that have to be reconciled. And I think that your proposal has brought this issue to the front.

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[23] For example, the Commission would be willing to consider the merits of an approach that would permit an offering to be made without a trustee, provided certain conditions were met. Under this approach, a trustee would be appointed on the occurrence of certain "triggering" events only, with the substantive provisions of the conditions included in the debt terms generally.

It has catalyzed effort on the part of all parties to begin to work together to work on behalf of the system, and to try to rationalize the system in a way which will balance the interests of investors as well as seeing to it that these redundancies and costs are reduced.

Mr. FIELDS. Let me pay back the compliment. I think the fact that you have stepped forward and engaged in the dialog on this particular issue has moved this debate forward in a very meaningful way.

And to go just a little bit further, you note in your testimony that the States have already taken steps toward eliminating duplicative securities registration requirements by, for the most part, exempting from blue sky regulation companies that meet standards for Exchange listed and NASDAQ national market system securities.

And while I applaud that effort to achieve a more uniform regulatory structure, which is of course one of the goals of the legislation, I note that your remarks are qualified by stating that the States have, for the most part, exempted these companies. What are the exceptions for the rule?

Mr. LEVITT. Well, there are a number of exceptions that bring into the fore subjective judgments. There are so-called "merit review" States. I think there are approximately a dozen States that subject companies to merit review. I have some ambivalence about this.

As a Federal regulator, and really as a philosophic matter, I believe that our system of full and absolute disclosure, which we spend so much time and thought and effort on, is the very best way to prepare investors to protect themselves.

I don't think any system, any system at all, can fully protect investors against their own foolishness. But if we are able to provide them with all of the facts that we can through disclosure, I think we can go a long way to providing them with protection.

On the other hand, with certain kinds of investments that I think are more questionable, investments such as blank check offerings, penny stocks, roll ups, limited partnerships, in those instances I think some subjective evaluation is probably appropriate. It's very difficult for the Commission to address all of these issues. That's where the partnership with the States becomes important.

As a general notion, however, I'm not comfortable with that subjective evaluation. I think that the proposal to codify the exemptions built into listed securities is probably a useful step to take.

Mr. FIELDS. Thank you, Mr. Chairman. The Chair's time has expired. The gentleman from Pennsylvania, Mr. Klink.

Mr. KLINK. Thank you very much. Mr. Chairman, you said in the opening text of your prepared statement that H.R. 2131 provides some provocative ideas on updating securities regulation, promoting market growth, and development in providing investor protection and confidence.

We've just gone through an extraordinary week where day after day the markets keep breaking new records. And I ask you, with that as background, are you using the term "provocative" in a kind way? Let me just ask you what you mean by that?

Mr. LEVITT. Yes. I am not using the word "provocative" in a pejorative sense at all. Let me say this, that I have learned as a non-

lawyer and as a first time civil servant, really, that any change in our great securities laws, any change whatsoever, whether it be a sentence, a phrase, or even a piece of punctuation creates such an outcry from the legal profession, from academia, from the press, from consumer groups, that I think that those changes have to be approached in a very measured, careful fashion.

Having said that, I don't think that there is anything in our society today that has moved as quickly and dramatically, in terms of change, as our markets. And I think, to see to it that our markets remain to be as good and sound as they are, and as competitive as they have been, and to be responsive to growing global competition, those markets have got to be sufficiently resilient that they can adapt to change.

That's why I believe that the chairman's bill brings to light issues that we really haven't discussed recently. Some of them we may agree or may disagree with, but I think it's terribly important that we have a forum on these issues. So when I say "provocative," I say it in the most constructive sense.

Mr. KLINK. It's apparent, and I know that in talking with our State in Pennsylvania, and with talking to others, that State regulators do have problems with H.R. 2131.

It's also very apparent by your response here today and by your testimony that you've had discussions with State regulators about that Federal-state partnership. Can you go a little more in depth on my time here as to what their reaction has been?

Mr. LEVITT. Sure. I think that the reaction of State regulators, by and large, to the proposals dealing with a word that is so dreaded in the minds of State regulators, "preemption." I try not to use it. I'll try to call it a "banana" instead of preemption.

But they are very concerned about taking away what they regard to be a terribly important proprietary right to protect the citizens of their State. And I understand that. I think that all of us that deal with investors feel very strongly about the importance of protecting investors.

So I think that they believe that elements of this proposal threaten the well being of investors in their communities. My own feeling about this area is that it is something that has evolved over a period of years. It is something that has led, in my judgment, to certain excesses.

At the same time, we don't want to sweep away all of it because of those excesses. I think the way to approach this would be in an incremental fashion. Moreover, for the first time, in a dialog with State regulators, that there appears to be a recognition that some of these excesses exist.

The States, in a very creative, forthright, and open way have appointed a blue ribbon committee to address some of the concerns cited by, occasioned by, this proposal. The committee is in the process of meeting as we talk today.

So I would say their attitude is one of concern, of apprehension, of fear, of protection for their investors. But at the same time, the States are coming forward openly and constructively to meet some of the issues highlighted by this proposal.

Mr. KLINK. If I could just ask the Chair's leniency for a moment? To that point, we've prepared a hypothetical question. And maybe

I sometimes don't understand as much about these matters as I'd like to. Let me ask you this hypothetical question.

Let's assume that H.R. 2131 were enacted into law as it has been written. And let's take a stockbroker from Kalamazoo, that he called a family from Kalamazoo and he tried to sell them stock in a small Michigan company.

The preemption of State investor protection laws in H.R. 2131 would mean that the transaction would be governed almost entirely by Federal law. Neither the local broker or the small company would be subject to any of the independent registrations or licensing requirements of the State of Michigan, if I understand it. Both of them, along with the local investor, would have to look to Washington DC if they had any problems, as I understand the bill.

On the other hand, consider the effect of H.R. 2131 if someone like Kirk Kerkorian were to launch a hostile tender offer for Chrysler Corporation. Chrysler is a huge multinational corporation that obviously does a lot of business in Michigan. But Chrysler also has millions of shareholders and does business in virtually every city and town throughout the Nation, in fact, around the world.

Nevertheless, H.R. 2131's repeal of the Williams Act would mean the Federal law would be entirely silent as to the rights and responsibilities of the respective parties to this multi-billion dollar transaction.

Not only would Federal law be irrelevant, Michigan's laws would likely be irrelevant as well. That's because the law that would govern the transaction would likely depend on where Chrysler, which in all likelihood is in the State of Delaware.

So, if my analysis here is correct, then H.R. 2131 could have the result of giving the Federal Government virtually complete regulatory authority over matters of local interest like the small brokerage transaction that took place in Calamus, Michigan, but it would give a few individual States virtually complete regulatory authority over matters of tremendous national importance like merger or takeover of many of the Nation's largest and most important industrial companies.

Have I missed anything in that, or am I completely off base?

Mr. LEVITT. You're citing two of many elements in this bill. And with respect to the first part of your question, in terms of supervision of brokers, it's my feeling, and it's the Commission's feeling, that the regulation of brokers should remain with the States in terms of licensing, in terms of regulating brokers.

At the same time we feel there should be greater uniformity, in terms of standards for holding up brokerage licenses, which has been really very troublesome for firms in terms of the time delay. And I think the States recognize it and are moving in that direction.

I think there is need for greater cooperation, and coordination, and planning to avoid stepping on one another's toes. For that reason we signed this memorandum of understanding with the States this week.

As far as the second part of your question is concerned, regarding the Williams Act, the Williams Act essentially is intended to provide investors with timely information about takeovers. I think certain aspects of the act could be streamlined.

Hovever, I have great reservations about doing away with the act because I think it provides a very important and very vital tool for investors to know about takeovers. Interestingly enough, I think that the Williams Act is looked upon constructively by leading elements in the brokerage community, and in corporate America, and in the investor community.

I think, again, addressing The Williams Act in terms of streamlining would be very useful, very constructive, and something that we shouldn't dismiss because we may have feelings about the overall act itself.

Mr. KLINK. Thank you very much. And I thank Chairman Fields for his indulgence.

Mr. FIELDS. The gentleman from Georgia.

Mr. DEAL. Thank you, Mr. Chairman. One State's securities administrators point out that the Securities and Exchange Commission reviews only about 50 percent of the investment company filings. And that State review of those filings is necessary in order to cover the cases not reviewed by the SEC.

I would like to ask you if the 50 percent that are not reviewed are simply the routine immaterial type updates of investment company registration statements? And, if so, would it be cost efficient for the SEC or the States to engage in a review of all of those?

Mr. LEVITT. The 50 percent that—well, let me put it this way—all new filings are reviewed by the Commission. All the significant filings are reviewed by the Commission. Those that are not, many of them are very routine kinds of filings.

I think that the 50 percent number is a somewhat distorting number, in terms of what the Commission is able to do with the really most significant filings.

Mr. DEAL. And you consider the reviewing process to be adequate for those that are being reviewed by the SEC, I assume?

Mr. LEVITT. Yes.

Mr. DEAL. The Commission has suggested a system under which States would assume regulatory responsibility for examining advisors who manage assets that are under the $5 million amount.

I would like to ask you if you can achieve any kind of uniformity or consistency with those advisors, if they were to move out of State, or if they were operating in a multistate area such as where we are here, or for those who would be dealing with wrap products that come from various States. How would you propose to deal with those kinds of problems?

Mr. LEVITT. When I first came to the Commission, I determined that a terribly important priority would be for the SEC to work as closely and as harmoniously with the States as we possibly could.

In the course of working toward a greater degree of uniformity and harmony, we recognized that one of the fastest growing elements in the investing community was the growth of investment advisors. There has been a virtual explosion in the number of advisors out there, and the ability of the Commission to do the job of inspecting and examining those advisors has diminished.

We can inspect smaller advisors, on average, once every 44 years, which is tantamount to no inspection. So the notion of dividing that responsibility and allocating to the States responsibility for inspect-

ing smaller advisors of under $5 million makes a great deal of sense in terms of leveraging our resources.

As to whether the States can harmonize the requirements imposed upon advisors, I think we can move toward that. There is no such thing as perfect harmonization, I've learned, particularly in government, just as there is no such thing as perfect communication.

But there is better harmonization. And I think that we've moved a great deal toward that in recent months and years. And I think that would be a commitment made by the Commission and, hopefully, by the organization that represents the States toward seeing to it that the job is done.

In any event, even with limited harmonization, which is certainly not what I would strive for, we are better off in terms of that allocation of resources than we are at the present time, with so few of those smaller investment advisors being inspected under the present system.

Mr. DEAL. I thank the gentleman. I yield back the balance of my time.

Mr. FIELDS. The gentleman yields back. The gentlelady from California.

Ms. ESHOO. Thank you, Chairman Fields. Chairman Levitt, would you State for the record whether you would support this bill, if it were considered today by the committee without any changes to it?

Mr. LEVITT. You know, I think that's kind of a hypothetical statement. I would be glad to support——

Ms. ESHOO. I know where I'm going.

Mr. LEVITT. I would be enthusiastic about elements of the bill, and I'm less enthusiastic about other elements of the bill. But I say again, with that caveat, that I think it's an extremely important service to the industry and to our investing community to have this dialog.

Ms. ESHOO. Well, I agree, obviously.

Mr. LEVITT. I might go on and say there are probably very few bills that I can think of that on first blush I would enthusiastically support every jot and tittle.

Mr. FIELDS. Will the gentlelady yield?

Ms. ESHOO. Certainly, Mr. Chairman.

Mr. FIELDS. I wonder if the chairman would support a work in progress?

Mr. LEVITT. Sure.

Ms. ESHOO. That's obviously what we're engaged in. But I think that there are some things that we need to appreciate as we are engaging in this endeavor; that the S&P 500 stock index has climbed 12.5 percent a year so far this decade, which is three times the rate of inflation; that the Dow Jones recently surpassed the 5000 marker.

It took over a century to reach 3,000, and in less than a decade we went from 4,000 to 5,000. That overall the stock markets are in the midst of the longest run in this century, which is really quite extraordinary, now about 5 years without a 10 percent drop in market value. So there is something to be appreciated about what we have achieved.

On the issue of suitability requirements and the institutional investors and their sophistication, at the last hearing we had entered into the record a list of the charities and institutions that were victims of the massive New Era fraud that was discovered earlier this year.

The list was 12 pages long, and the entries were simply extraordinary. The American Red Cross, the Biblical Theological Seminary, Landes Homes Retirement Community, the Kings Christian School, the National Coalition Against Pornography, the Salvation Army, the University of Pennsylvania Cancer Center, and the Philadelphia Orchestra Association are just a few of the hundreds of institutions listed.

I understand that the SEC may be looking into this matter, so I will not ask you any specific questions about it. But is it fair to conclude that these charities are examples of at least some of the institutions that would have fend for themselves in dealing with Wall Street, if we eliminate the suitability requirement?

Mr. LEVITT. You're right on. I think the question of suitability is probably the most difficult and complex issue that we have to deal with with respect to this bill. I experienced that first hand, in terms of negotiating with the Derivatives Policy Group Agreement, which I think is a landmark consensus resolution between public and private sector.

But when we got to the issue of suitability, it was almost impossible to resolve because the group was pulled between the poles of those who would say "caveat emptor" on the one hand and on the other hand those who would say, "we're just babes in the woods." We've purchased billions of dollars worth of securities but we're innocents. Neither of them, in my judgment, are correct. Somewhere between the two is a rational and imperfect answer.

I don't know of any way to address the suitability issue which could satisfy the thousands of municipalities out there run by individuals or groups that have inadequate experience or training to monitor their fiscal affairs, or philanthropic groups and foundations and others that really lack the experience.

So merely saying that we'll classify an institution as being qualified to make those judgments, I think, is inadequate to the complexity of this issue. I guess what I'm saying to you is that it's a very tough issue, that I don't side with those who would say caveat emptor, nor do I side with those who would say we're babes in the woods.

But I think we've got to approach this carefully because there are risks involved, some of which you've just pointed out.

Mr. OXLEY [presiding]. The gentlelady's time has expired. The gentleman from Washington State.

Mr. WHITE. Thank you, Mr. Chairman. And thank you, Chairman Levitt, for being here. I'd like to follow up on this issue of suitability.

I noticed in your testimony you made the point that you thought this area was not yet ripe for legislation and it would be better to let the rulemaking process continue here. And I'd like to pursue that a little bit.

On the one hand, I agree with you in a lot of areas it's better if Congress doesn't act. I'd like to see, particularly in the area of

where things can be worked out on private parties, I'd like to see that happen.

I don't necessarily feel the same way when we're talking about a regulatory agency, since I think it's better for Congress to set these policies rather than a regulatory agency.

And I'd be interested in your thinking why you think we should proceed with rulemaking rather than let Congress make some of these decisions?

Mr. LEVITT. Well, I don't know that either of us are going to come to the perfect solution, but I have, since I've been at the Commission, studiously tried to avoid asking Congress for anything.

Mr. WHITE. I can understand that.

Mr. LEVITT. With all due respect, I don't know when we're going to get it or what we're going to wind up with. And the Commission, I think, has a more intimate ongoing concern about the issues which deal with our markets and the kind of dangers that arise sometimes suddenly and unexpectedly that can impact our markets.

A response to those issues sometimes doesn't lend itself to the prolonged process involved in a legislative response. The question of suitability is not a black or white question. I think Congress tends to deal best with black and white issues. And because of that, I urge great caution as we approach this issue.

Mr. WHITE. I appreciate that. And, frankly, that is exactly what we're here for, to make sure we don't inadvertently get off the track. But let me just pursue this to make sure I understand it.

I mean, this isn't a case, it seems to me where we have to worry too much about delay. I mean we have a suitability provision in this bill, so it doesn't seem to me the reason not to go forward now would be because it is going to take too long, because we're right on the threshold of doing something.

I got the sense from your remarks that you may have the feeling that the Commission, because of its day to day dealings with the market, may have a little better sense of the subtleties and maybe you're better equipped to deal with it in a more rational way than we are. Is that essentially what you're thinking is?

Mr. LEVITT. I think what I'm saying is the solution to the suitability issue set forward by this bill is one that I have reservations about.

The NASD has surfaced a suitability proposal which has been the subject of public comment. Part of the Commission's very good process, I believe, is to see to it that all elements in the community have an opportunity to evaluate and analyze the consequences of any rule or regulation. And we're in the midst of that process now.

We're analyzing the public comments on all sides of this issue. Even a cursory review of the letters that have come in, and the comments that have come in from people on all sides of the political spectrum, lead me to the conclusion that this is one very difficult tough issue.

I would rather let that process work its way through than to codify something which I think will have a number of unintended consequences.

Mr. WHITE. Let me ask you also about the margin requirement suggestions in this bill. Would it be safe to say that that's the most

far reaching or innovative or maybe provocative provision in this bill? Would that be your sense?

Mr. LEVITT. No. I would not say that this is the most provocative and far reaching part of this bill.

Mr. WHITE. Tell me just your general reaction to the changes suggested in the margin provisions of the bill?

Mr. LEVITT. Again I go back to my experience in dealing with customers, retail customers, and living through all kinds of markets; it's very difficult to tell which elements are the most important elements of the bill in terms of public confidence, in terms of seeing to it the participants of the markets recognize that the markets are sound, the markets are safe, the markets are reliable.

Margin requirements were put in for a very good reason. And I believe that as we consider a change to those requirements, we've got to be very, very cautious. Now at the same time, having said that, I believe that there are some aspects of the margin requirements which have probably outlived their usefulness.

As I said before, we are now in the midst of an increasingly competitive global economy. We've got to be certain that all elements in the community are able to compete in that environment effectively. I am concerned that the current margin regime maintains a disparity between broker dealers and banks, for instance.

Our proposal, the Commission's proposal is somewhat different than the bill's proposal because it takes a significant though incremental step to level the playing field with respect to debt securities. It removes the margin requirements for debt securities, which is a major, major factor in terms of many of our institutional firms. And, I think, that incremental step would be a constructive step.

I think going beyond that when you deal with investors and investor credit and take away from the SROs the ability to establish margin maintenance requirements. I think that that is a step that I am uncomfortable with. It goes too far. It's uncalled for.

I think an incremental step at this point would address some of the competitive problems that we have. I think it would be acceptable to the industry, and would be a constructive way of approaching it without the risks that would be involved in going as far as this bill proposes to go.

Mr. OXLEY. The gentleman's time has expired. The gentlelady from Oregon.

Ms. FURSE. Thank you, Mr. Chairman. Welcome Chairman Levitt. I just need to ask you a couple of questions about the Williams Act. Are the tender offer disclosure of the Williams Act especially burdensome, in your judgment?

Mr. LEVITT. No.

Ms. FURSE. Now we've heard, and I've heard said that it imposes some unnecessary costs on corporations that plan friendly mergers. But isn't it true that the Williams Act is irrelevant for friendly mergers in that most of them are done through techniques other than tender offers?

Mr. LEVITT. I think that's so.

Ms. FURSE. In your testimony, Chairman Levitt, you suggested that rather than repealing the Williams Act, Congress could consider strengthening it by narrowing the tender window for the filing of the 13(d) filings?

Do you have any suggestions for us of how short that window should be? Should it be—I know the techniques have changed so completely, we're not waiting for the post office to——

Mr. LEVITT. Right.

Ms. FURSE. [continuing] send things back and forth. But do you have any suggestions for us on that?

Mr. LEVITT. It's very difficult for me to say that the number of days should be 15 or 9 or 10, or what have you. But I think that's the direction I would move in. And I'd prefer not pinning down a specific number because I'm really not prepared to do that at this point.

Ms. FURSE. And can you explain to me how shortening that window would improve market efficiency and investor protection?

Mr. LEVITT. I think it would just limit the amount of time that other market forces can be at play out there. To that extent I think it could be somewhat more efficient than it is now.

Ms. FURSE. Several weeks ago we heard a witness here who stated that the costs imposed by securities regulations was becoming, "a significant threat to the competitiveness of the U.S. markets." Do you agree, Chairman Levitt, with that statement?

Mr. LEVITT. I do not agree with that statement. I've made a major effort to travel around the world, sometimes with our SROs, to recruit companies to list in U.S. markets. So I've had first hand experience with international markets, probably more than any of my predecessor chairs.

Our markets are vastly superior to any other market in the world. Every emerging market uses our markets as a standard in terms of regulation; certainly our costs have not made our markets lack competitiveness.

At the same time, I think we've got to be totally vigilant to see to it we don't become complaisant. And accept the fact that we don't have to constantly reevaluate everything that we do to see that we can't reduce some of them, or can't combine some of them, or can't eliminate some of them. But to suggest that our markets are impeded by costs in some way, I think is a gross overstatement.

Ms. FURSE. Thank you. I know that Daimler Benz was so anxious to get into our markets that they were willing to——

Mr. LEVITT. As are the Chinese using our regulatory pattern—I'm going to Moscow on Monday—for the same reason. Every Third World market, every emerging market, doesn't take the easiest way to establish instant credibility.

They take our way because internationally U.S. standards, U.S. markets are the markets to get credibility the finest way, the fastest way, the most efficient way.

Ms. FURSE. Thank you. I just have one more question. I gather from your testimony you suspect that one reason H.R. 2131 proposes to make the delivery of prospectuses optional is that some people have become frustrated with their complexity. And I know that you've pointed out that that frustration might be justified.

But I wonder if, instead, shouldn't we look at the example set by the mutual fund industry? These fund companies have worked hard to prepare their prospectuses in plain english, and the result has been generally very, very good.

And the mutual fund industry is enjoying unprecedented prosperity. Do you agree with me that this is the direction we should be encouraging the rest of the industry to head to?

Mr. LEVITT. I'm concerned that in the understandable effort toward full and complete disclosure through the years we've, in some instances, created documents that have become bloated. The kinds of investors in our markets today, a large number of whom are relatively unsophisticated, are confounded by what we regard to be full and total disclosure.

So the Commission has made a great effort to try to get these documents written in simple plain english. I think we've made great progress, as you point out in the mutual fund field. I think we can do a lot more with respect to prospectuses, and I think that should be the thrust of our direction. I think that that would be a very constructive effort.

I think we've got to study the question of prospectus delivery to see to it that we're not merely following a rule for the sake of following a rule, but that the prospectuses do what they are intended to and get to the people they are intended to get to. And, again, by adhering to the absolute letter of the law, we've sometimes lost sight of the functionality of how we do this.

And I think that's why this particular bill raises a legitimate issue. Now, how we address it is another matter.

Mr. OXLEY. The gentlelady's time has expired.

Ms. FURSE. Thank you.

Mr. OXLEY. The gentleman from Oklahoma.

Mr. COBURN. Thank you. Mr. Chairman, a couple of questions. First of all, in terms of the suitability requirements, there is nothing in this bill that would change the fraud statutes in terms of somebody fraudulently deceiving someone, to your knowledge, is that correct?

Mr. LEVITT. That's correct.

Mr. COBURN. So many of the things associated, possibly, with the New Era deal, which may have dealt with fraud, would not be addressed in this legislation?

Mr. LEVITT. That's true. But so many of the areas that come to the Commission's attention are not clearly questions of fraud. There are other issues that are involved and they're not always black and white.

Mr. COBURN. Right. Let me ask you again. I have some reasonable concern about some of the margin changes in this legislation.

Would you just kind of, in a very short period of time, outline those areas that you agree with in this legislation and those areas that you disagree with or you think are worrisome at this time, in terms of the margin reform that's there?

Mr. LEVITT. Well, I think one area of reform would be to remove from margin restrictions the issuance of debt. In our proposal we exempt most debt securities from Federal margin provisions after 30 days. And we also suggest that the self-regulatory organizations should continue to maintain their role in setting margin.

In this bill, it maintains the Federal Reserve Board role in setting margin, but it severely limits the SROs margin setting ability. And I regard that to be terribly important. They're really in the

trenches working with the firms, working with investors. And I think that's quite important.

Mr. COBURN. And just to follow up, would the absence of prepurchase or predelivery prospectus delivery, would that yield to another complication in terms of suitability and another defense? As you described earlier, we're not all babes in the woods and we're not all sophisticated, somewhere in between.

But do we not by eliminating prospectus delivery early or prior to the transaction allow another defense for us not to be responsible for what we purchased, no matter how complicated the prospectus may be?

Mr. LEVITT. I guess we might. I guess we might.

Mr. COBURN. Let me follow up with just one other question. You stated just a moment ago that you thought that you'd made great progress in terms of prospectus in terms of full disclosure, and getting that to something maybe the average consumer out there, who now is participating in the market and can understand.

I quite frankly would tend to disagree with that, looking at the last few prospectuses that have come across my desk. And I just wonder is there some plan or some mechanism where we might have English so that those of us that aren't attorneys might be able to understand full disclosure?

Mr. LEVITT. I think so. I think you may recall some months ago, I took a fairly convoluted series of paragraphs from a prospectus and sent them to Warren Buffett and said, see if you can put this into plain English. And he boiled it down to three or four sentences which were so clear and lucid.

I did that to get public attention drawn to the fact that people who are putting together these documents were being mindless about what they did and how they did it.

We've made a major initiative at the Commission to expedite the clearing of prospectuses that are written in plain English and bouncing back those that are not. We've even gone so far as to retain an outside academic, an English professor from Rutgers, to help us in the Commission to write out rules and regulations in ways that are more comprehensible. We're going to make a major initiative at this. Will we get to every prospectus? No. But we have made progress.

I'll make a point of sending you some instances of mutual fund prospectuses which are really so vastly superior to anything we've seen before, and some of the things that are coming through our office as well. Has there been enough progress? No. But it's a major initiative.

Mr. OXLEY. The gentleman's time has expired. The gentlelady from Illinois.

Mrs. COLLINS. Thank you, Mr. Chairman. Mr. Chairman, in your testimony you suggest that we should delete the suitability provisions of H.R. 2131, in light of the fact that there is a current NASD rule proposal before the Commission that would extend sales practice and suitability rules to the Government securities market and put into place institutional investor interpretation to give security funds guidance regarding their suitability obligations to institutional investors.

Now isn't this NASD rule the result of legislation that was adopted by this subcommittee and cosponsored last year by Markey, Fields, Dingell, and Moorehead, the leadership of the subcommittee, and the full committee enacted it into law in 1993?

Mr. LEVITT. Yes.

Mrs. COLLINS. Well, don't you think that there ought to be a presumption that brokers are professionally responsible for making suitable recommendations for their institutional customers?

Mr. LEVITT. Again, that might be an easy presumption to make at the start. But as you work through individual cases of this, it's not quite as simple as that. And that I believe that brokers clearly have a responsibility for a measure of disclosure.

But I cannot lay all of the responsibility on the brokers. I think investors have a substantial amount of responsibility to use the information that is available to them to make certain basic judgments.

Mrs. COLLINS. Isn't it also true that brokers and institutional investors are free to enter into contracts to further define the nature of their relationships?

Mr. LEVITT. I guess I have difficulty in accepting the notion that an institutional investor, merely because he's called an institutional investor, is all the same.

There are some institutional investors that are better able to make investment decisions than any broker alive, and there are others that are truly babes in the woods. It's very hard to draw that distinction.

Mrs. COLLINS. In your testimony you say that the Commission favors an approach that would maintain the existing presumption that broker dealers are responsible for making suitable recommendations to their institutional customers while permitting flexibility, in appropriate circumstances, for parties to clarify the nature of their relationship.

Mr. LEVITT. I stand by that.

Mrs. COLLINS. So, isn't the purpose of the NASD or New York Stock Exchange suitability rules to assure that complaints about suitability are resolved on a case by case basis?

Mr. LEVITT. I think the NASD proposal addresses that. The proposal is out for comment now. And we've got comments all over the lot on this issue.

What I'm asking this committee to do is to allow that process to work itself through rather than codifying a suitability requirement which I think is as close to impossible as anything you could possibly get at.

Mrs. COLLINS. Why do you think it's close to impossible?

Mr. LEVITT. Because this issue is subtle in terms of interpretation, that I think it's much better to allow the NASD process to work itself through, to allow the public comment process to come about, and to make some judgments at that point which will have as few imperfections as we possibly can get. I don't think that the legislative process is the best forum to do this.

Mrs. COLLINS. Okay. Yesterday the Dow Jones Industrial Average closed at 5100, establishing yet another record. I recently read a news report that indicated that the Dow has set about 70 new

records this year. That number is apparently the highest total for 1 year since 1925.

We will discuss a lot of specific ideas here today; and perhaps for just a moment you could tell us whether there is any crisis in our markets that requires us to rush to pass a sweeping rewrite of security laws? One question.

Second question, do our laws or regulations need emergency surgery, or would you recommend instead a thorough and careful checkup with some policy revisions designed to maintain continued good health?

Mr. LEVITT. It's like have you stopped beating your wife, your question. In answer to your second question, it must be done with the greatest of care, the greatest of caution.

Having said that, my experience in running a variety of different kinds of businesses is that the best time to look at change is at a time when things are going well, not when things are going badly.

So in answer to the first part of your question, the fact that our markets are doing extremely well, the fact that our markets are reaching new highs, suggests to me that we can examine various significant structural parts of our markets, but we should examine them with care and with caution.

Any danger to investor protection or systemic risk or the process of capital formation are dangers that have to be carefully considered and measured. Rather than going from point A to Z, if Z is our ultimate goal, and Z represents a substantial risk, I would prefer to go to D, G, and L, see how it goes, and then consider the next step.

Mrs. COLLINS. Thank you.

Mr. OXLEY. The gentlelady's time has expired. The gentleman from California.

Mr. COX. I thank the chairman. I want to hear Chairman Greenspan later on. And, I expect, that in addition to the very specific parts of this legislation that relate to responsibility of the Fed, we may be talking to him about more general economic trends.

But since there has been some discussion this morning about the Dow Jones reaching new highs, and so on, I thought I would just explore a couple of basic points with you on that subject. Roughly how long have we been using the Dow Jones Industrial Average?

Mr. LEVITT. I'm told that since the turn of the century, created by Charles Dow.

Mr. COX. And is the Dow Jones industrial average adjusted for inflation?

Mr. LEVITT. I think not.

Mr. COX. Well, that's right, it isn't. And wouldn't, therefore, if life were going along in a rather normal way, the Dow sort of reach new highs on a regular basis, just because it's not adjusted for inflation, so long as we have inflation?

Mr. LEVITT. I'm not sure I understand what you are saying. Are you——

Mr. COX. I guess what I'm worried about is that that if we keep—I want to make sure we instill and continue to instill investor confidence in the market.

And I just worry, when we discuss these things casually, that we may conveying the notion to the uninitiated that this is some sort

of a tulip bulb craze. And that as we hit all these new highs that maybe this can't last and truly the thing is going to turn around on us.

I haven't done the figures, but I would venture to say, having looked at them and done them before, that if one adjusts for inflation, the record highs look a lot different.

And I just would ask you whether you have any concern at all that somehow we're flirting with a Dow that's too high or something?

Mr. LEVITT. No. No, I don't have that concern. I think that characteristically there are probably as many analysts who feel the market is low as those who feel that the market is high. That's the nature of our markets.

On the other hand, I do have concern about the numbers of investors today that I regard to be less sophisticated investors, and investors who haven't experienced other parts of the market other than rising markets. That's why I think it's important to be certain that we have a very open dialog about markets and what they are. And that people understand markets.

But I think you're quite right, it's too easy to develop a scare scenario based upon the fact that the markets are in new territory. I don't represent that at all.

Mr. COX. I take it from your last statement that you'd also agree that the market will fluctuate?

Mr. LEVITT. Yes.

Mr. COX. On page 7 of your testimony, to get to the specifics of the legislation, you raised a point that is intriguing and perhaps is a simple and straightforward point, but I can't tell without asking further.

In addition, you say, the Commission believes that there is room to modernize the exemption from Federal registration of intrastate rate and certain other offerings. Just as States should defer to national offerings, so should the Federal Government defer to the States where local offerings are concerned.

For other categories of offerings, several alternative options could be explored. One possible option would be to allow for an offering to be reviewed either at the Federal level or at the State level at the issuer's option. An interesting idea.

I'm wondering to what it applies, because explicitly in your testimony you say here you are not talking about intrastate offerings, you are talking about certain other offerings. What are they?

Mr. LEVITT. Well, this option could apply to offerings of certain sizes or categories. However, it is something actually that we would prefer to determine at a later time, rather than declaring right now exactly what they would be. Because it's something that is, as you know, the subject of intense debate, and I'd rather reserve that.

Mr. COX. I see my red light's going on. Is there anything that you could fill that empty vessel with in your testimony?

Mr. LEVITT. Why don't I submit to you the basis of this recommendation and give some alternative ideas? I'm reluctant to cite a specific case until we've really done more work in terms of ventilating the idea and talking to people who have different views on it.

Mr. COX. I thank you.

Mr. OXLEY. The gentleman's time has expired. The gentleman from Michigan?

Mr. DINGELL. I'd like unanimous consent that my opening statement be placed in the record.

Mr. OXLEY. Without objection.

[The prepared statement of Hon. John D. Dingell follows:]

PREPARED STATEMENT OF HON. JOHN D. DINGELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

I commend the chairman of the subcommittee for holding this hearing today.

I believe that is vital to engage the expertise of the Securities and Exchange Commission in an effort to fundamentally rethink, let alone recraft, the nation's system of regulation of our capital markets. As the record of our first hearing clearly established, this system of regulation has produced the most liquid, deepest, most efficient, honest and open securities market in the world. In that regard, I am pleased to welcome the chairman of the SEC and I look forward to receiving your testimony on H.R. 2131.

I note that, while your testimony lists seven provisions of H.R. 2131 under the heading "Legislative Concepts that the Commission Supports," the SEC actually opposes the last four of these provisions—section 4 on securities margin, section 5 repealing tender offer regulation, section 6 on prospectus delivery, and section 14 repealing the Trust Indenture Act. I hope that your testimony clarifies this matter so that we have a clear and honest understanding of what you support and what you do not so that we can engage in an open and honest dialogue to improve this legislation.

I understand that the chairman of the Board of Governors of the Federal Reserve System will appear before the subcommittee later today to testify solely on the issue of margin reform and section 4 of H.R. 2131. Notably, I would observe that neither the SEC nor the Fed support the bill's margin provision. I look forward to learning more about this complicated subject. However, on the basis of the record that we do have at present, I believe that the SEC's suggested approach is a better starting point for our deliberations on a solution to industry complaints on the subject of margin regulation. With all due respect to my good friend Alan Greenspan, his proposal for trifurcating margin regulation—with securities credit extensions by broker-dealers regulated and overseen by the SEC and SRO's, bank securities credit extensions regulated and overseen by their respective primary banking regulators, and extensions of securities credit by other entities not regulated at all if the lender is not otherwise subject to comprehensive federal safety and soundness oversight—is a formula for disaster. And I categorically reject it.

Again, I thank the chairman of the subcommittee for scheduling this important hearing. I look forward to working with him and with the other Members of this subcommittee to improve the laws governing the fair, honest, and efficient operation of our markets and the protection of investors therein.

Mr. DINGELL. Thank you, Mr. Chairman. Mr. Levitt, welcome to the committee. Your statement here is a statement not only of yourself but of the Commission?

Mr. LEVITT. Yes.

Mr. DINGELL. That raises then an interesting question. As I look in the testimony's Executive Summary, I note on page 2, beginning with the item on Securities Margin Requirements, section 4; Prospectus Delivery, section 6; Tender Offer Regulations, section 5; Trust Indenture Act, section 14; a difference between your testimony and what the heading implies.

The heading of the page says "Legislative Concepts that the Commission Supports." I note at the bottom of page 12 and the top of page 13 of your statement, your comments are quite different on the subject of securities margin requirements. This is, what you say in your statement is quite different than the heading of the Executive Summary.

"The Commission is concerned however that the approach proposed in H.R. 2131 does not appear to take all these considerations

into account." It goes on to say, "The Commission instead has proposed a more limited alternative approach: codification of the agreement that was negotiated earlier this year between the Commission staff and three major securities firms." Your Executive Summary is different than that and indicates that you support that change.

Moving onto the prospectus delivery questions, your heading indicates, again, that these are legislative concepts that the Commission supports. However, I note at page 14, in the middle of the page, your statement says, as follows: "The Commission agrees the existing system does not serve either issuers or investors as well as we would like."

But you go onto to say, "As a general matter, the Commission agrees that these studies should be completed before significant legislative revisions to the prospectus delivery process are considered. In the interim, however, the Commission would support the sections' grant of exemptive authority to the Commission, which would authorize the Commission to exempt certain offerings or issuers from prospectus delivery." And then there is an extensive footnote at the bottom of the page.

Moving on to Tender Regulation Offer, section 5. "The Commission believes that the Williams Act provisions work well and serve a vital market function, and, therefore, does not support their substantial modification."

You go on however, to say, "The Commission could support (and has in the past supported) certain modifications to Exchange Act section 13(d)."

I note then at the bottom of page 15 your statement says, "The Commission believes that the Williams Act provisions have worked well and continue to work well, and therefore does not support the Act's repeal." There seems to be some modest difference there.

Moving onto the Trust Indenture Act, section 14, you indicate that you support the provisions of the committee bill. But I note, at page 16, you say: "The Act was amended most recently in 1990"—I believe this was referred to in the comments of the gentleman from Illinois—"at the Commission's request, in order to provide the Commission with general exemptive authority to streamline the trustee conflict provisions, and to facilitate shelf registration.

You go onto to say, "Prior to completion of such a study, however, the Commission believes it is inappropriate to recommend outright repeal or fundamental revision of the Act."

I wonder if you would take a look at the difference that I find here between your Executive Summary heading and the language in your testimony and perhaps help us? I wonder if you would take a look and would assist us in addressing that question.

While the Executive Summary may not be in fact in total conflict with your statement, it appears that there is some misleading possibility here, and the possibility of your summary being misquoted as indicating support for sections of the bill which your statement does not indicate you support.

Mr. LEVITT. As I listen to the various examples that you cite, my response would be that it's the concept that we support rather than a specific legislative idea in almost every instance that you've cited.

Mr. DINGELL. Well, do you support the concept of repealing the Trust Indenture Act, which is in the bill? I don't think you do. Your statement says you do not.

Mr. LEVITT. I think what our feeling about the Trust Indenture Act is that we have some reservations about the Act's viability, but it's not one that we're prepared to—we're not prepared to embrace the notion of having it repealed without a full study.

Mr. DINGELL. Well, the answer with regard to the repeal of the Trust Indenture Act is you don't support that. But you say that's a concept that the Commission supports.

I'm asking you to review the two and come up with something which will enable the committee to function on the basis of two documents which you have submitted to us. One, the Executive Summary, and two, your statement which is at significant variance with either the core language or the impression that one receives from reading the legislative concepts, at page small Roman ii.

Mr. OXLEY. The gentleman's time has expired.

Mr. LEVITT. One more last response. With respect to the Trust Indenture Act, we might very well support it.

Mr. DINGELL. But will you do so at this time?

Mr. LEVITT. No. We recommend——

Mr. DINGELL. Don't you think, to assist this committee to understand—I'm quite accustomed to receiving delphic statements from witnesses, but I'm quite unaccustomed to accepting them. And my problem here is I want to know what it is the Commission really feels and thinks.

Mr. Chairman, in order to straighten out this glitch in the record, I would ask that I be permitted 3 additional minutes?

Mr. OXLEY. The gentleman has requested an additional 3 minutes. Is there an objection?

[No response.]

Mr. OXLEY. Hearing none, the gentleman may proceed.

Mr. DINGELL. You've got an Executive Summary which tells us one thing and your statement which tells us a different thing. I'm asking you to rhyme it and give us something which enables the committee to understand what it is that the Commission really favors.

I'm also trying to get a record here which is not going to lead you to being quoted in subsequent discussions in this committee, and the floor, and in other places as having favored things which you say you do not favor in your statement. So I'm asking you to make a very careful correction.

I will be delighted to send you a letter on this matter. But you and I are old friends and I have enormous respect for you. I know you want to correct these things, and so I'm asking you to do so.

Mr. LEVITT. I will do so. Why don't we send you a response and clarification.

Mr. DINGELL. I would appreciate it if there'd be a discussion with Ms. Washington or Mr. Forde, so you and your people will more fully understand the concerns I have, on the basis of the legislative concepts that the Commission supports at small Roman ii, which I think leads to a conclusion or a group of conclusions that you don't want and I assuredly do not.

Mr. LEVITT. Well, I have great respect for your experience in this area. And if we have created confusion either by the headings that we've put on there, which I think could be confusing, and if this could lead to——

Mr. DINGELL. Perhaps a useful revision of the Executive Summary is in order. And perhaps that could more gracefully be done, and at the appropriate time you could resubmit that to us.

And I would ask unanimous consent that the Commission be permitted to resubmit the Executive Summary which will be helpful to them, and to me, and to everybody else here, in understanding what they really mean, and perhaps conform it with the language that my dear friend Mr. Levitt has given us here.

Mr. OXLEY. Without objection.

[No response.]

Mr. OXLEY. I understand the chairman is perfectly willing to participate in that exercise and——

Mr. LEVITT. Yes.

Mr. OXLEY. [continuing] it is so ordered.

Mr. DINGELL. Thank you. I yield back the balance of my time.

[The material follows:]

SECURITIES AND EXCHANGE COMMISSION,
WASHINGTON, DC,
December 4, 1995.

The Honorable JOHN D. DINGELL,
Ranking Member,
Committee on Commerce,
2328 Rayburn House Office Building,
Washington, DC 20515.

DEAR CONGRESSMAN DINGELL: This letter is intended to clarify the Commission's testimony on HR 2131 delivered to the Subcommittee on Telecommunications and Finance during the Subcommittee's hearing on November 30th. I regret that the headings in the testimony and the executive summary caused confusion in creating the impression that we support more provisions of HR 2131 than we do. When we chose the heading, "Legislative Concepts that the Commission Supports," we intended to indicate that we could support the SEC's legislative recommendations that followed the particular heading in our testimony, not necessarily the related legislative proposal that appears in HR 2131. I am sorry for the confusion, and I hope that this helps to clarify the Commission's position.

I have forwarded a copy of this letter to Chairman Fields and have requested that it be included in the hearing record.

Sincerely,

ARTHUR LEVITT,
Chairman.

cc: The Honorable Jack Fields,
Chairman, Subcommittee on Telecommunications and Finance
The Honorable Edward J. Markey,
Ranking Member, Subcommittee on Telecommunications and Finance

Mr. OXLEY. The gentleman from New York.

Mr. FRISA. Thank you, Mr. Chairman. Welcome Chairman Levitt, it's good to have you before us again. I'd like to, if I could, explore a little bit further the relationship and the scheme between Federal and State regulation.

I think it's apparent that both the Congress and the Commission have determined over the years that a disclosure-based system is really most appropriate. The greater the disclosure, the better that informed investment decisions may be made. I think we've seen, though, that some States have gotten into requiring substantive standards be satisfied in terms of price, terms and conditions.

And I'm wondering what your feelings might be, for the record, with regard to moving away from those requirements which could cause issues to either not be made or could delay. And I guess in certain cases, considering how varied those substantive requirements might be, drive up the cost of compliance for issuers.

Mr. LEVITT. Well, I think the question of overlap and redundancy is something that is of concern to the States, and is of concern to the Commission as well. And I think we are beginning to make progress in terms of reconciling that.

I believe that this question of subjective evaluations does create some problems. That where that would be appropriate, in the case of roll ups, and limited partnerships, and penny stocks, and blind pools.

I see less reason for that in terms of exchange-listed securities, this exemption could well be codified and that would be a step in the right direction.

Mr. FRISA. Thank you. I'd like to move onto another area, which is the EDGAR system which, as you know, we've been working on, actually I might say, closely with the Commission, and Commission staff, and yourself. I'd like to acknowledge the assistance and cooperation that the Commission has given.

And also I think it is an appropriate time to state for the record that tomorrow the Commission is holding a forum, together with the National Academy of Science to further explore modernization, privatization of EDGAR.

And I think that's an excellent opportunity to take input from our very best minds with regard to technology so that the system that we are now faced with, and that you inherited at the Commission for too many years, has cost too much money and has probably not provided the service that we'd like to see it provide.

And I know we are in agreement, the committee, and yourself, and the Commission are in agreement on that. And I think we're moving quickly yet thoughtfully together toward determining the very best fate for the EDGAR system. And I think it's important that we publicly acknowledge that the Commission has been moving and working closely with us.

In fact, I'll be issuing publicly next week a report that analyzes from the Congress's and the subcommittee's standpoint, some of the issues regarding EDGAR. But we'd like to acknowledge and thank you and your staff for the input that you've given.

Mr. LEVITT. Thank you.

Mr. FRISA. I yield back, Mr. Chairman.

Mr. OXLEY. The gentleman yields back. Chairman Levitt, on the margin issue that was discussed earlier, isn't it correct that the SEC margin proposal maintains margin requirements on debt securities during the first 30 days of issuance?

Mr. LEVITT. That's correct. Yes.

Mr. OXLEY. And I wonder if you could discuss with the committee the potential competitive disadvantage that our markets might have with European markets, for example, in the margin area? And I understand the need to balance safety and security versus competitiveness, but where do you position yourself on that particular issue?

Mr. LEVITT. Well, I'm more concerned about competitiveness issues that U.S. brokerage firms might have with U.S. banks in that regard. I think that we address that issue in terms of the arrangement that was worked out with three of the largest securities dealers in the United States, with respect to in effect, eliminating margin requirements beyond the first 30 days on debt securities. At the same time we keep with the Federal Reserve Board the right to establish margins and the right of the SROs to establish ongoing maintenance requirements.

I think that provides us with investor protection. It's an incremental step toward a kind of relief for the most difficult problem that U.S. brokerage firms have with respect to competition with banks, and doesn't run afoul of jeopardizing investor interests.

I have great, great reservations about taking the SROS out of the arena of establishing margins, or doing anything that would change the margin requirements right now with respect to equities.

Mr. OXLEY. In the hearings on Glass-Steagall repeal held before this subcommittee, Chairman Greenspan cautioned us several weeks ago that the proposed repeal of Glass-Steagall was insufficiently visionary because it did not eliminate unnecessary regulation in the content of repeal.

Do you feel that an approach on margin reform that maintains the sweep of margin regulation for entire classes of securities suffers from the same defect, given the fact that the Board of Governors believes that outright repeal of Section 7 and Section 8(a) would not harm the safety and soundness of the financial system?

Mr. LEVITT. No. I've heard arguments on both sides of that issue with great fervor, and great passion, and great intellectual backing. And I am not prepared to consider the Draconian step of, in effect, sweeping away all margin requirements at this point in time. It sends the kind of message which I think unnecessarily and possibly is risky to send.

I think that if the goal is to reduce some competitive disadvantages, I think that we can accomplish incrementally. I think when we're dealing with markets and we're considering the implications of markets that have performed so well and so resourcefully, an incremental approach is a far better approach.

Particularly with an issue, above and beyond the merits of the issue, that is so rife with misinterpretation, that we shouldn't send a message that we don't intend to send. I think going slowly in this area is something that I would urge this committee to do.

Mr. OXLEY. In response to a question from Mr. White earlier, where he asked whether the margin reform in the bill was the most, I think he used "provocative" and "far reaching" of the bill, and you said, "No." The obvious question then is, what is?

Mr. LEVITT. I think the portion dealing with the banana would be the most provocative.

Mr. OXLEY. And, finally, and this is an open-ended question, using the prerogative of the Chair to ask, you talked with Mr. Cox and others about the Dow Jones being at new highs. Just generally, why are those markets at such historic highs, in your opinion?

Mr. LEVITT. Well, I think a variety of factors. I think, in the first place, a very underlooked factor has been the astonishing growth

and productivity of U.S. manufacturers. I think that our international competitiveness has been a remarkable success story of this recovery.

I think the fact that we've had stable interest rates, lowered interest rates has been very encouraging. So the that there is a sound basis for market levels where they are, I think, in terms of price-earnings ratios, in terms of all the historical standards, I think that our markets are sound.

That's not to say that markets won't go up and won't go down. They often do for reasons that are unrelated to fundamentals. But over a period of time fundamentals determine, in my judgment, the direction of markets. And at this point in time for the past number of years, the fundamentals have become increasingly sound.

Mr. OXLEY. Some would say that the very good prospect of a balanced budget also may fuel that growth.

Mr. LEVITT. I would say that the notion of a balanced budget has been a basically constructive factor in so far as market analysts are concerned.

Mr. OXLEY. Thank you. The Chair's time has expired.

Mr. FIELDS. Mr. Levitt, let me just say, I appreciate your time and your patience, and your willingness to come and share thoughts with us today.

When the bill was introduced in August, or excuse me, late July, the purpose was to begin a conversation. And you have made that conversation a true dialog.

This piece of legislation is a work in progress. Market transparency, the security offered to the investor is not on the table, but it is important to examine all aspects of our securities laws. Certainly you've moved us forward on this very important issue.

The committee will now stand in recess until 1 p.m. when we have Mr. Greenspan.

AFTERNOON SESSION

Mr. FIELDS. The second hearing on the Capital Markets Deregulation and Liberalization Act of 1995 will be called to order.

Chairman Greenspan, let me say on behalf of the subcommittee we appreciate you being with us today. We know that your time is limited. We will stay within the time parameters that you have given us. We are anxious to hear your testimony.

When you conclude, the Chair may have to make a decision to limit the time of members in asking questions. And I would assume that you would not mind taking written questions thereafter?

Mr. GREENSPAN. Certainly not.

Mr. FIELDS. Chairman Greenspan, please proceed.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. GREENSPAN. Thank you very much, Mr. Chairman. It's certainly a pleasure to have the opportunity to present the views of the Federal Reserve Board on securities margin requirements this afternoon. The Board commends the subcommittee for its willingness to reconsider the public policy objectives of margin regulation and to consider amendments to the relevant statutes.

Today I shall present the Board's long standing views on the objectives of Federal Reserve margin regulation and the need for statutory amendments to promote those objectives.

The statutory basis for Federal margin regulation is contained in Section 7 and 8(a) of the Securities and Exchange Act of 1934. Reflecting views that were widely held when the 1934 Act was passed, Congress apparently intended this margin regulation to achieve three main objectives: First, to constrain the diversion of credit from productive uses in commerce, industry, and agriculture to presumed speculation in the stock market; Second, to protect unsophisticated investors from using margin credit to establish excessively risky positions; And third, to forestall excessive fluctuations in stock prices.

The Board believes that experience in regulatory changes during the 6 decades since the passage of the 1934 Act support the conclusion that margin regulation is not the best way to achieve those objectives. Concerns about a diversion of credit which apparently weighed most heavily in 1934 were misplaced, in our judgment. Customer protection concerns today are more reliably addressed by other regulations and policies applicable to the issuance and distribution of securities and to the conduct of broker-dealers. Finally, the view that the existing margin statutes are necessary to control stock price volatility is not supported by empirical evidence that has accumulated since 1934.

A number of statistical studies of the relationship between margins and stock price volatility have been conducted. And the preponderance of that evidence suggests that changes in margins have not affected price volatility in any measurable way.

The Federal Reserve Board also has doubts about the effectiveness of margin regulation for achieving the purposes of Section 7 and 8(a) of the 1934 Act. The underlying assumption is that the ability of investors to leverage can be restricted by regulating margins on loans collateralized by securities. While in 1934 many investors may have had no other means of borrowing funds to invest in securities, today investors have many alternatives. With these alternatives available, margin requirements cannot effectively limit leverage.

In our view, Federal oversight of securities credit makes sense only as part of broader systems to ensure the safety and soundness of financial institutions such as broker-dealers and banks. As I shall discuss later, however, the most effective approach to prudential oversight of securities credit depends on the nature of the overall safety and soundness regime applied to the financial institution.

The best approaches to prudential oversight do not appear compatible with the statutory frameworks of Section 7 and 8(a) of the 1934 Act, which, as I have mentioned earlier, was designed for entirely different purposes.

The Board has evaluated the margin provisions of the Capital Markets Deregulation and Liberalization Act of 1995, that is H.R. 2131, against the view that the objective of margin oversight should be the safety and soundness of financial institutions subject to comprehensive prudential oversight.

H.R. 2131 would repeal Section 8(a) of the 1934 Act and amend Section 7 substantially. We believe that repeal of Section 8(a) is

consistent with safety and soundness, but we have difficulty reconciling the amendments to Section 7 with that objective.

Section 8(a) restricts broker-dealers from borrowing from lenders other than broker dealers and banks when using exchange-listed equity securities as collateral. Removal of these financing constraints would promote the safety and soundness of broker-dealers by permitting more financing alternatives and hence more effective liquidity management.

Section 7 is the section that provides the Board with the authority to regulate securities credit. Among the amendments to the section contained in H.R. 2131, we view the restrictions on the authority of SROs to impose margin requirements on their members as fundamentally inconsistent with prudential objectives.

More generally, the Board has concluded that because Section 7 was originally enacted for completely different purposes, margin regulation cannot be successfully reoriented toward prudential objectives through amendments to that statute.

Although regulatory burdens associated with that statute could be reduced through amendments, the residual framework would continue to impose compliance costs and would not effectively serve any public policy purpose.

Instead, we believe that the safety and soundness objective that is appropriate for margin oversight could best be achieved by repealing both Section 7 and Subsection 8(a) of the 1934 Act.

I have already discussed the case for repeal of Subsection 8(a). Repeal of Section 7 would promote safety and soundness by leaving responsibility for oversight of securities credit to those entities responsible for comprehensive oversight of financial institutions. Specifically, securities credit extended by broker-dealers would be overseen by the SEC and the respective SROs.

Securities credit extended by banks would be supervised by their respective primary banking regulators. Extensions of securities credit by other entities would be subject to Federal oversight only if their overall safety and soundness is subject to such oversight.

In the case of broker-dealers, the Federal Reserve Board sees no public policy purpose in our being involved in overseeing their securities credit extensions. The self regulatory organizations and the SEC are much more likely to develop an oversight regime that is most consistent with their overall approach.

If Section 7 were repealed, the Board would expect to work with the other Federal banking regulators to develop a framework for the oversight of bank securities credit that is consistent with the overall framework of banking supervision and regulation.

From its perspective as a banking regulator, the Board sees existing margin regulations under Section 7 and 8(a) as an anomaly, reflecting the non-prudential purposes underlying the existing margin statutes and regulations.

These margin regulations involve a regulatory assignment of a maximum collateral value of equivalently a minimum loan to value ratio for securities. Banking regulators typically leave such judgments to bank management, and seek through general policy guidance and on-site review of loans to ensure that banks' judgments are consistent with safety and soundness.

Given the opportunity, we would urge banking regulators to take a similar approach to the supervision and regulation of loans against securities collateral. The Board sees no compelling public policy reason for Federal oversight of securities credit extended by lenders that are not subject to comprehensive Federal safety and soundness oversight.

In any event, with the exception of loans involving employee stock ownership plans, securities credit extensions by lenders other than broker-dealers and banks currently are negligible. Most recent data, incidently, show credit extensions by such lenders total just over $400 million.

Some may argue that the approach to margin regulation that the Board is advocating would not provide a level playing field for all providers of securities credit. It is not clear how relevant an issue that would be, if so.

The Board does not believe that competitive equity requires that an identical oversight regime be applied to all players in the marketplace, provided competition from whatever source ensures adequate customer choice.

So long as we have a limited safety net for banking institutions, there will inevitably be some disparities in the competitive environment for financial institutions. However, we at the Board believe that their impact on oversight competition is minor and the endeavor to rectify them is far more costly than any perceived benefits.

In conclusion, Mr. Chairman, the Federal Reserve Board believes that Section 7 and Subsection 8(a) of the 1934 Act may not effectively serve the purposes for which they were originally enacted.

Repeal of these sections would leave Federal oversight of securities credit extensions by broker-dealers to the SROs and the SEC, and would allow banking regulators to develop an approach to oversight of bank securities credit that is more compatible with their overall approach to bank safety and soundness.

We understand that implementation of this approach raises many important issues that would take some time to resolve. The SEC has expressed concerns about the interplay of margin with other financial responsibility rules for broker-dealers, competition between market participants, the solvency of financial institutions, and systemic issues.

We look forward to working with the SEC and with other members of the Working Group on Financial Markets to determine what other regulatory changes would be necessitated by repeal of Section 7 and 8(a). In addition, the SROs would need to work with the SEC to modify their margin rules, a process that likely would take some time.

Therefore, if Congress decides to repeal Section 7 and 8(a), it may wish to consider delaying the effective date of such action. Thank you very much, Mr. Chairman.

[The prepared statement of Alan Greenspan follows:]

PREPARED STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Thank you for this opportunity to present the views of the Federal Reserve Board on securities margin requirements. The Board commends the Subcommittee for its willingness to reconsider the public policy objectives of margin regulation and to

consider amendments to the relevant statutes. Today, I shall present the Board's views on the objectives of Federal Reserve margin regulation and the need for statutory amendments to promote those objectives. As I shall discuss, the Board has concluded that federal oversight of securities credit is appropriate as part of comprehensive systems of oversight of safety and soundness of certain lenders—broker-dealers and banks. However, the Board is not convinced that the existing statutes authorizing Federal Reserve margin regulations—section 7 and subsection 8(a) of the Securities Exchange Act of 1934—effectively serve the purposes that apparently motivated their passage. Consequently, as it has for many years, the Board continues to believe that self-regulatory organizations should be given greater responsibility for margin regulation. Repeal of sections 7 and 8(a) of the Securities and Exchange Act of 1934 would leave federal oversight of securities credit extensions by broker-dealers to securities regulators, including self-regulatory organizations (SROs). It would also allow banking regulators to develop an approach to prudential oversight of securities credit extensions by banks that is more compatible with their overall system for overseeing bank safety and soundness.

We understand that implementation of this approach raises many important issues that would take some time to resolve. The SEC has expressed concerns about the interplay of margin with other financial responsibility rules for broker-dealers, competition between market participants, the solvency of financial institutions, and systemic issues. We look forward to working with the SEC and with other members of the Working Group on Financial Markets to determine what other regulatory changes would be necessitated by repeal of sections 7 and 8(a). In addition, the SROs would need to work with the SEC to modify their margin rules, a process that likely would take some time. Therefore, if Congress decides to repeal sections 7 and 8(a), it may wish to consider delaying the effective date of such action.

Objectives of Margin Regulation

As I noted, the statutory basis for federal margin regulation is contained in the Securities Exchange Act of 1934, which gives the Federal Reserve Board the authority to regulate margins—that is, the minimum downpayments or, equivalently, the maximum collateral values for loans—on all securities other than government securities and other "exempted" securities. Reflecting views that were widely held when the 1934 Act was passed, Congress apparently intended this margin regulation to achieve three main objectives: (1) to constrain the diversion of credit from productive uses in commerce, industry, and agriculture to "speculation" in the stock market; (2) to protect unsophisticated investors from using margin credit to establish excessively risky positions; and (3) to forestall excessive fluctuations in stock prices.

The Board believes that experience and regulatory changes during the six decades since the passage of the 1934 Act support the conclusion that margin regulation is not the best way to achieve those objectives. Concerns about a diversion of credit, which apparently weighed most heavily in 1934, were exaggerated. It is now widely recognized that the use of credit to finance securities does not materially reduce the amount of credit available for other uses. The borrowed funds do not disappear; rather, they are transferred to the seller, who reinvests the proceeds.

Customer protection concerns today are more reliably addressed by other regulations and policies applicable to the issuance and distribution of securities and to the conduct of broker-dealers. These include disclosure requirements, sales practices rules, and investor education efforts such as those recently initiated by the Securities and Exchange Commission (SEC).

Finally, the view that the existing margin statutes are necessary to control stock price volatility is not supported by empirical evidence that has accumulated since 1934. Numerous statistical studies of the relationship between margins and stock price volatility have been conducted, and the preponderance of that evidence suggests that changes in margins have not affected price volatility in any measurable way. To be sure, experience with the effects of changes in securities margin requirements is both limited and dated (initial margin requirements on equities have changed only about twenty times since 1934 and have not changed at all since 1974). But the view that changes in margin requirements do not affect asset price volatility is also supported by numerous studies of exchange-traded futures and options, including contracts on equities and equityindexes.

The Federal Reserve Board also has doubts about the effectiveness of margin regulation for achieving the purposes of sections 7 and 8(a) of the 1934 Act. The underlying assumption is that the ability of investors to leverage can be restricted by regulating margins on loans collateralized by securities. While in 1934 many investors may have had no other means of borrowing funds to invest in securities, today investors have many alternatives. With these alternatives available, margin requirements cannot effectively limit leverage.

In the Federal Reserve Board's view, federal oversight of securities credit makes sense only as part of broader systems to ensure the safety and soundness of financial institutions such as broker-dealers and banks. Safety and soundness oversight necessarily must address all sources of risk to those institutions. When such institutions make loans against collateral in the form of securities, the margin required is an important element in the risks they face and, as such, is an appropriate object of prudential supervision and regulation.

As I shall discuss later, however, the most effective approach to prudential oversight of securities credit depends on the nature of the overall safety and soundness regime applied to the financial institution. Indeed, there are several regulatory models for achieving safety and soundness—all potentially effective. U.S. authorities take quite different approaches to ensuring the safety and soundness of broker-dealers and banks, for example. Different approaches to oversight of securities credit may well be desirable. In any event, the best approaches to prudential oversight do not appear compatible with the statutory framework of sections 7 and 8(a) of the 1934 Act, which, as I have noted earlier, was designed for entirely different purposes.

The Margin Provisions of H.R. 2131

The Board has evaluated the margin provisions of the Capital Markets Deregulation and Liberalization Act of 1995 (H.R. 2131) against the view that the objective of margin oversight should be the safety and soundness of financial institutions subject to comprehensive prudential oversight. H.R. 2131 would repeal section 8(a) of the 1934 Act and amend section 7 substantially. The Board believes that repeal of section 8(a) is consistent with safety and soundness but has difficulty reconciling the amendments to section 7 with that objective.

Section 8(a) restricts broker-dealers from borrowing from lenders other than broker-dealers and banks when using exchange-listed equity securities as collateral. Removal of these financing constraints would promote the safety and soundness of broker-dealers by permitting more financing alternatives and hence more effective liquidity management.

Section 7 is the section that provides the Board with authority to regulate securities credit. Among the amendments to the section contained in H.R. 2131, the Board views the restrictions on the authority of SROs to impose margin requirements on their members as fundamentally inconsistent with prudential objectives. The inclusion of these provisions in the bill evidently reflects dissatisfaction by some firms with their SRO's administration of margin requirements on debt instruments traded in the over-the-counter markets. If there have been problems in this area, those problems should be resolved by the members of the SROs, if necessary with the assistance of the SEC. The Board does not believe that the solution to these problems is to abandon the principle of self-regulation of broker-dealers.

Although we support a lowering of regulatory burdens in general, the Board finds it difficult to support the various exclusions from margin regulation that the bill would provide. These proposed exclusions would appear to reflect a view that the objective of margin regulation should be customer protection, an objective that I have indicated the Board believes is far more effectively addressed through other regulations and initiatives.

Ultimately, the Board has concluded that, because section 7 was originally enacted for completely different purposes, margin regulation cannot be successfully reoriented toward prudential objectives through amendments to that statute. Although regulatory burdens associated with the statute could be reduced through amendments, the residual framework would continue to impose compliance costs and would not effectively serve any public policy purpose.

An Alternative Approach to Margin Reform

Instead, the Board believes that the safety and soundness objective that is appropriate for margin oversight could best be achieved by repealing both section 7 and subsection 8(a) of the 1934 Act. I have already discussed the case for repeal of subsection 8(a). Repeal of section 7 would promote safety and soundness by leaving responsibility for oversight of securities credit to those entities responsible for comprehensive oversight of financial institutions. Specifically, securities credit extended by broker-dealers would be overseen by the SEC and their respective SROs. Securities credit extended by banks would be supervised by their respective primary banking regulators. Extensions of securities credit by other entities would be subject to federal oversight only if their overall safety and soundness is subject to such oversight.

In the case of broker-dealers, the Federal Reserve Board sees no public policy purpose in it being involved in overseeing their securities credit extensions. The SROs

and the SEC are much more likely to develop an oversight regime that is most consistent with their overall approach. The Board has already incorporated SRO rules into its margin regulations for some debt instruments and securities options. Where possible, the SROs have set margin requirements that better reflect the credit risks to lenders than the uniform and arbitrary initial requirements that currently apply to equities. The Board would expect that if the SROs were given responsibility for initial margins on equities, they would replace the existing requirements with more risk-sensitive standards. The self-interest of the SROs in the safety and soundness of their members and the integrity of their markets should ensure that such changes are consistent with safety and soundness. If these incentives proved inadequate, the SEC would have the authority to enforce changes in SRO oversight.

Just as oversight of the safety and soundness of SROs is best left to the SROs and the SEC, prudential oversight of banks is best left to the respective banking regulators. If section 7 were repealed, the Board would expect to work with the other federal banking regulators to develop a framework for the oversight of bank securities credit that is consistent with the overall framework of banking supervision and regulation. From its perspective as a banking regulator, the Board sees existing margin regulations under section 7 and 8(a) as an anomaly, reflecting the non-prudential purposes underlying the existing margin statutes and regulations. These margin regulations involve a regulatory assignment of a maximum collateral value (or, equivalently, a minimum loan-to-value ratio) for securities. Banks make far larger volumes of real estate loans and auto loans than securities loans. But, except in limited instances required by statute, banking regulators do not regulate collateral values (or, equivalently, loan-to-value ratios) for such assets. Banking regulators typically leave such judgments to bank management and seek, through general policy guidance and on-site review of loans, to ensure that the banks' judgments are consistent with safety and soundness.

Given the opportunity, we would urge banking regulators to take a similar approach to the supervision and regulation of loans against securities collateral. General guidance on prudential considerations with respect to such lending might be provided in the form of a supervisory policy statement. Examiners could then ensure that lending decisions by banks were consistent with those prudential considerations. This approach would allow banks discretion in setting collateral requirements to take account of factors such as the price volatility and market liquidity of the securities, the time period allowed for borrowers to eliminate collateral deficiencies, and the general creditworthiness of the borrower.

The Board sees no compelling public policy reason for federal oversight of securities credit extended by lenders that are not subject to comprehensive federal safety and soundness oversight. In any event, with the exception of loans involving employee stock ownership plans (ESOPs), securities credit extensions by lenders other than broker-dealers and banks currently are negligible (most recent data show credit extensions by such lenders totaled just over $400 million). Credit extensions that are part of ESOPs already have been exempted from most requirements of margin regulations, including minimum initial margins. Other lenders have been important in the past, but generally only when margin requirements have been set higher than currently and well above levels necessary for prudential reasons. If broker-dealers and banks are not required to set margins at levels higher than necessary for safety and soundness, it seems unlikely that other lenders would again play a prominent role.

Some may argue that the approach to margin regulation that the Board is advocating would not provide a level playing field for all providers of securities credit. It is not clear how relevant an issue that would be, if so. The Board does not believe that competitive equity requires that an identical oversight regime be applied to all players in a marketplace, provided competition from whatever source ensures adequate customer choice. Banks and broker-dealers already compete effectively with one another in a wide range of markets, including markets for credit secured by government securities, despite fundamental differences in approaches to prudential oversight of the two types of entities. In any event, the Board would expect that the repeal of section 7 would over time lead both the SROs and the banking regulators to adopt more flexible and more compatible approaches to prudential oversight of credit extensions collateralized by securities.

With respect to competition from other lenders, as I have argued, such competition is unlikely to be serious if securities and banking regulators do not handicap broker-dealers and banks by requiring margin levels higher than necessary for safety and soundness. More fundamentally, the Board is concerned by the implications of a view that the notion of a level playing field requires federal oversight of all providers of services that compete with services provided by regulated financial institutions. So long as we have a limited safety net for banking institutions, there will

inevitably be some disparities in the competitive environment for financial institutions. However, we believe that their impact on overall competition is minor and the endeavor to rectify them is far more costly than any perceived benefits.

In conclusion, the Board believes that the primary objective of federal oversight of securities credit should be the safety and soundness of institutions, such as broker-dealers and banks, which are subject to comprehensive prudential regulation. Subsequent experience, analysis, and regulatory and market developments support the conclusion that section 7 and subsection 8(a) of the 1934 Act may not effectively serve the purposes for which they were originally enacted. Repeal of these sections would leave federal oversight of securities credit extensions by broker-dealers to their SROs and the SEC and would allow banking regulators to develop an approach to oversight of bank securities credit that is more compatible with their overall approach to bank safety and soundness.

The Board looks forward to working with the SEC and other members of the Working Group on Financial Markets to determine what other regulatory changes would be necessitated by repeal of sections 7 and 8(a). If Congress decides to repeal sections 7 and 8(a), it may wish to consider delaying the effective date of such action to allow time for such interagency discussions and time for the SROs to modify their margin rules.

Mr. FIELDS. Chairman Greenspan, thank you very much for your testimony. Let the Chair alert the members that Chairman Greenspan does need to leave at 1:50. The Chair will recognize himself for 5 minutes. In deference to other members, so that I don't consume time where members cannot ask questions, I'll ask only one, Mr. Chairman.

You closed out your testimony by saying that the margin rules no longer serve the purposes for which they were originally intended. My question is an open-ended question. What developments in the market have occurred that have led you to this particular view?

Mr. GREENSPAN. There are basically two issues involved. Subsequent academic research and experience in the market place had forced us to rethink many of the original notions which underlie the 1934 Act.

More importantly, perhaps, there has been such an extraordinary proliferation of financial instruments and financial products, and changes in market structure that the ability to finance virtually any instrument by a credit-worthy borrower is far larger and less restricted than it would have been in the period leading up to the 1934 Act.

In that regard, we take two positions. One is that we think, conceptually, the statute does not create, in our view, what it was intended to. And, perhaps more importantly, the markets have so changed that even if there was a conceptual basis for it at the time of the act, markets have rendered that substantially inconsequential.

Mr. FIELDS. Maybe I'll violate my previous statement by asking one more question. That is, what would be the benefits if we were to reform the margin rules?

Mr. GREENSPAN. Well, first of all, let me stress the fact that what we are advocating is not the elimination of margins. On the contrary. Margins and collateral are a very crucial issue in the financial system for promoting safety and soundness.

What we are arguing for is a change in the incidence of where those margin rules emanate, and that, considering what the modern financial system is, a review of the structure of how margins

are developed within the financial system is long overdue, in our judgment.

Mr. FIELDS. Thank you, Mr. Chairman. The gentleman from Pennsylvania, Mr. Klink.

Mr. KLINK. Thank you very much, Mr. Chairman. I have many questions and I hope that we'll be able to follow up in writing. I just wanted to touch on a couple of things.

What is the chance that if we eliminate virtually all of the restrictions on the use of margin that portfolios are going to become more leveraged and our stock market become significantly more volatile?

Mr. GREENSPAN. I would say the evidence suggests that there is very little chance of that largely because the ability to leverage at this stage with the types of products which currently exist in the financial market and which enable virtually any credit-worthy borrower to leverage to whatever extent he would like to, using varieties of products, options, futures, and the like.

And it strikes me that the change in margin, the incidence of margin creation that we are advocating, would have no measurable effect on the capability.

Mr. KLINK. Your testimony indicates that the empirical evidence leans in that direction, that volatility would not substantially increase, but the evidence seems to be a little bit thin. You know, I was wondering if you agree about whether or not the potential dangers created by excessive leveraging of a portfolio, which I think is illustrated pretty fairly in the case of Orange County, California where they didn't use margins but they used derivatives, that there seems to be some evidence that there still could be some volatility in the marketplace.

Mr. GREENSPAN. I'm not arguing that one cannot have inappropriate leverage and leverage which would induce risks. I merely am raising the question about using the most sophisticated statistical techniques that we have available. We've got a huge amount of data on prices of all varieties of markets. None of our most elaborate econometric techniques has been able to find any measurable relationship between margins, or I should say, margin regulation and the degree of price volatility whether that's for equity prices, for bonds, or for futures. It apparently doesn't exist. I grant you that it might exist as a theoretical question. One can produce a model in which that would occur.

I'm merely saying that having looked at the data in fairly extensive detail, we have not been able to find any reasonable basis to assume that that relationship exists.

Mr. KLINK. But, Chairman, you do make the point in your testimony, I was looking at page 3, that you say that in the 61 years that have transpired since 1934, that we have very limited data on the changes of the margins, only 20 times since 1934. And the margin regulations haven't changed at all since 1974.

Just before that you make the point, though, that a number of statistical studies of the relationship between margins and stock price volatility have been conducted, and the preponderance of that evidence suggests a change in the margins have not effected the price volatility in a measurable way.

Given the fact that there has been so little changes in margin activity over a 61 year period, how good is that empirical data that we have showing the volatility of stock prices?

Mr. GREENSPAN. Well, we actually have substantially more information than strictly looking at margins in so-called cash markets, in which the statement you made is obviously correct.

What we have is a very substantial amount of evidence on changing margins in futures and options contracts related to equities from which one can derive the conclusion. If margins would have the significant effect on price volatility in the cash margin in the cash markets, we're very likely to find it in all of these collateral markets as well.

But in all of the evidence that we've looked at, granted that there is a limited period here with respect to the cash market since 1934, the evidence just does not show up. And collateral examination of all sorts of other price relationships and all sorts of so-called speculative markets also show no evidence.

We have a huge amount of information, for example, in the commodities markets for wheat, corn, soy beans, stock index futures, and the like. Again, you cannot infer, by the tools that we have available which are very sophisticated, any relationships.

Mr. KLINK. Thank you, Mr. Chairman. I yield back the remainder of my time.

Mr. OXLEY [presiding]. The gentleman from Washington State, Mr. White.

Mr. WHITE. I thank you, Mr. Chairman. And I thank you, Mr. Chairman, for coming to testify to us today. And it's such an opportunity, I can't resist digressing just a little bit to ask what I think is a very important question, that's a little bit off the subject of this bill. And that has to do with the Federal budget.

I want to tell you that I have never served in public office before. And I remember very clearly the time 2 years ago when I was thinking about running for office, and I can tell you that at that time the received political wisdom was that it probably was impossible to balance our Federal budget.

We had all these entitlements that you'd have to deal with. And, frankly, in our political system there just wouldn't be the political will to accomplish that. And I can remember thinking last week, after we went through all this turmoil of shutting down the Government, and everything, I got on the airplane to go back to Seattle for Thanksgiving.

It's a 5-hour flight and it gave me quite a bit of time to reflect. And it was my view that the budget passed by Congress recently, and the agreement signed by President Clinton that we will balance over a 7-year period, was actually a pretty remarkable accomplishment, given the conventional political wisdom of just a few years ago.

And I couldn't help by being struck by your testimony earlier this week when you said that there's been a very deep-seated skepticism in the financial markets that this Government has the capability of coming to grips with a chronically disabling budget deficit And it struck me that perhaps there'd been a conventional wisdom in the financial markets similar to the conventional wisdom in the

political area that we've seen. And I wanted to ask you these questions kind of based on that view.

Has there been a change, in your view, in the conventional wisdom of the markets about the ability of this Government to get its budget in order? Is there a confidence now that we will balance it? And, if so, what will happen if we don't get that job done?

Mr. GREENSPAN. Well, the evidence very clearly suggests that the degree of skepticism which was very thick for a number of years for very good reasons, has very markedly declined. And there are essentially two reasons for that.

One is that the normal presumption that budgets with so-called smoke and mirrors would come up and look balanced 3 years in the future and it never happened, finally ran into a very extraordinary fact, the one that you mentioned, namely that the Congress has literally put together such a budget.

Second, the President of the United States has credibly agreed that a balanced budget is something that must be reached within a reasonable period of time. And the confluence of those forces, in my judgment and my experience, had at no time been even close.

I think the result of this is that the financial markets which were 200 basis points or more higher a year ago, for the long end of the bond market, are essentially discounting a significant budget package which will move us credibly, and I underline the word "credibly," toward a balanced budget. And, clearly, should that emerging degree of optimism be brutally shattered, there are consequences. The consequences would be that we would retrace part of that decline in long-term interest rates and that would affect mortgage rates, obviously the interest-sensitive areas of our economy. And the effect on the economy is clearly adverse.

Mr. WHITE. Let me just show you a chart here and ask if this is kind of what you were referring to? Because here is a chart of the 30 year T-bill. And you can see that it was going up, up, up here [indicating]. This happens to be November 8, 1994, the date of the last election.

I take it that you are referring to, when you talk about the decline in the interest rates, you are talking about this decline that really started almost exactly a year ago and has gone down ever since. Are you telling us that if we don't get the budget balanced, this is likely to start to go back up?

Mr. GREENSPAN. Part of that decline—I don't know the proportion of it, but it is nonetheless a significant part of that decline—in my judgment, reflects a growing expectation in the marketplace that there will be a credible budget bill which will bring us to a balance within a reasonable future.

Mr. WHITE. Thank you very much, sir. And thank you, Mr. Chairman.

Mr. OXLEY. The gentleman's time has expired. The gentleman from Michigan, Mr. Dingell?

Mr. DINGELL. Thank you, Mr. Chairman. Mr. Greenspan, welcome to the committee. I'd like you to focus your mind, if you please, on your testimony, on page 8.

You say the Board sees no compelling public policy reason for Federal oversight of securities credit extended by lenders that are

not subject to comprehensive Federal safety and soundness oversight.

So as I gather, you are essentially talking then about a trifurcated margin regulation. Once set of regulations for banks, one for SROs, and one for people who are regulated by SEC, is that right?

Mr. GREENSPAN. That is correct.

Mr. DINGELL. Now, let's go back and see how that would have worked. Do you remember the Hunt case?

Mr. GREENSPAN. I do, indeed.

Mr. DINGELL. Where the Fed had to rush in and bail out the Hunt brothers because they had tried to corner the securities market?

Mr. GREENSPAN. The silver market.

Mr. DINGELL. Oh, the silver market. That's right. And they borrowed enormous sums of money to do so. And they very nearly succeeded but didn't quite make it. Some of that was money that they'd borrowed on margin.

So here we would have three different regulators. You'd have them subject to the regulations at the SEC, or the NASD, or the New York Exchange, or whatever it might happen to impose. You'd also have another set of regulators, which would be the commodity regulators, CFTC and their exchanges. And then you'd have the banks.

Now, as I read it, the banks, as you say, would not be compelled at all to confront any margin limitations on loans which might be undertaken for purposes of—well, the banks would be under banking regulators, but you'd have a group who you say would not be subject to regulation under any Federal regulatory structure. How would that have worked?

Mr. GREENSPAN. Well, first of all, let me say, Congressman, that the first and most important issue of what the appropriate collateral and margin is is initiated by the lender. The self-interest of lenders to put up adequate collateral is terribly relevant.

In the silver case, for example, silver is an obviously interesting element of collateral because its value can change very abruptly, as indeed it did.

Mr. DINGELL. That's true on securities too.

Mr. GREENSPAN. And it's true on securities. Some securities less so than others. And the vast majority of protection that occurs in the marketplace is engendered basically by the prudential endeavors on the part of lenders to make sure that the monies they lend out are secure.

As far as banks are concerned, they make all sorts of loans to all sorts of people for all sorts of different types of collateral. What we as bank supervisors do is endeavor to evaluate the processes they employ in doing so to make certain that the overall institution is a safe and sound institution. Similar types of credit——

Mr. DINGELL. All right. I understand that. But that leaves us then in a situation where your concern would be the solvency of the bank. The SEC and the SRO would have a different concern. Their concern would be the fact that they don't want to have excessive volatility in the market which creates risk for the market and risk to the other investors in that market.

Mr. GREENSPAN. Yes and no. I would say that the SROs' major interest is basically prudential margins to protect the institution, the clearing house, the exchange, or what have you. The SEC clearly has capital rules which are also involved for the purpose of protecting the safety and soundness of broker-dealers.

Mr. DINGELL. That's true. But on the margin question——

Mr. GREENSPAN. I was about to address that. It is true that, so far as the SEC is concerned, they hold the view that the issue of margins should be for more than the prudential purposes on the belief that margins can reduce the degree of volatility and presumed risk as a consequence of price fluctuation. We respectfully disagree with them on that issue.

Mr. OXLEY. The gentleman's time is expired.

Mr. DINGELL. I have a question I'd like to submit in writing.

Mr. OXLEY. The Chair would state for all the members that the chairman has agreed to take written questions since the time is difficult both for us on the floor vote as well as the chairman's schedule. The gentleman from Ohio.

Mr. GILLMOR. Mr. Chairman, do you feel that the Capital Markets Bill, the bill that we have before us, goes far enough to effect the necessary changes in Federal regulation to adequately address the changes in the current marketplace?

Mr. GREENSPAN. We have not had a chance to actually go through the bill in detail, other than its margin considerations. And I'm not sure we have the expertise that we would feel comfortable with to give you an overall view in that regard.

Mr. GILLMOR. Let me ask you, in terms of the market itself. The market does to a degree impose its own margin requirements. Do you think it does it as well as the 1934 Act?

Mr. GREENSPAN. The importance of the private market in creating collateral and margins is the major barrier to risk and loss. No matter what regulatory structure we impose on it, we only have a relatively minor effect and cannot substitute for the fundamental self-interest of a lender who is lending out his money at risk. And you can depend, I should hope, that he is in a far better position than any of us to make a judgment as to the kind of party with whom he is dealing, and therefore how much collateral is appropriate.

Mr. GILLMOR. I sat on the Banking Committee in my first term when we did the Savings and Loan bill. Sometimes those lenders make some misjudgments.

Mr. GREENSPAN. Indeed they did.

Mr. GILLMOR. With respect to the proposal the SEC has circulated on margin reform, do you believe that it is consistent with the Board's view of appropriate margin reform? And does the SEC's approach effectively achieve the purposes of Section 7 and Section 8(a) of the 1934 Act?

Mr. GREENSPAN. Well, they, as I understand it, are in agreement for repeal of Section 8(a). The position of the SEC, relevant to a package they developed in conjunction with meeting with several investment bankers, is something which we believe is an advance on existing legislation.

And, indeed, if no further action were taken, we would think support of that position would clearly be in the Nation's interest. Our

view, however, is that we believe we can go a bit further and improve the system in so doing.

Mr. GILLMOR. Thank you very much, Mr. Chairman. I yield back.

Mr. OXLEY. I thank the gentleman for yielding back. Mr. Chairman, we appreciate your kindness in being here with us. And we are actually going to get you out of here 5 minutes earlier than you'd anticipated, which rarely happens around here. But we look forward to having you back before the subcommittee again. With that, the hearing is adjourned.

[Whereupon, at 1:45 p.m., the subcommittee was adjourned.]

CAPITAL MARKETS DEREGULATION AND LIBERALIZATION ACT OF 1995

TUESDAY, DECEMBER 5, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON COMMERCE,
SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2154, Rayburn House Office Building, Hon. Jack Fields (chairman) presiding.

Members present: Representatives Fields, Oxley, Gillmor, White, Markey, Manton, Furse, Eshoo, and Klink.

Staff present: David L. Cavicke, majority counsel; Linda Dallas Rich, majority counsel; Tim Forde, minority counsel; and Consuela Washington, minority counsel.

Mr. FIELDS. This will be a fairly long day. So we are going to move forward as expeditiously as possible. And since we are in a new room, we hope that our members can find this particular room.

Today marks the third in this subcommittee's hearings on the Capital Markets Deregulation and Liberalization Act of 1995. At our first hearing on this legislation, we heard the testimony of recognized experts in the capital markets of securities regulations, including academics and former SEC Commissioners from both sides of the aisle.

At that hearing, the panel voiced unanimous support for the elimination of unnecessary regulatory burdens, including eliminating State registration of federally registered securities issues.

At the second hearing on this legislation, just last week, Securities and Exchange Commission Chairman, Arthur Levitt, provided his views on the initiative, as did Alan Greenspan, the Chairman of the Board of Governors of the Federal Reserve.

Chairman Levitt provided insightful commentary on the need to eliminate the regulatory waste and duplication that is burdening our capital markets. Chairman Levitt merits our recognition for the excellent efforts of the Securities and Exchange Commission to achieve our goal both in the area of prospectus simplification, modernization of the EDGAR system, the general regulatory review undertaken by the task force led by Phillip Howard and, yes, the banana he referred to, the harmonization of the Federal and State regulatory regimes that govern our capital markets.

Chairman Greenspan provided us with compelling reasons for reexamining the need for the margin requirements of the Securities and Exchange Act of 1934. The capital markets bill will amend

those requirements to eliminate some of their anticompetitive and superfluous provisions; after hearing Chairman Greenspan's testimony, however, we might all consider the even more deregulatory approach the Federal Reserve Board advocates while preserving for the SRO's the ability to regulate margin.

Today, we will hear testimony from witnesses representing a host of additional and equally important constituencies. My goal in conducting such extensive hearings on this legislation is to be true to my word—to make sure we have the benefit of the views of the many different participants in our capital markets that are so profoundly affected by the regulations of securities as we bring this work in progress toward successful completion.

Today, we are having alphabet soup; we will hear testimony from representatives of the SIA, PSA, ICI, ABA, MFA, NASAA, and GFOA. We will also hear from expert practitioners and academics in specialized fields of securities law, including blue sky laws and even the Trust Indenture Act.

Each of these witnesses brings valuable insights to the process. We will hear why there is a need for clarification of the suitability obligations that apply to broker/dealers who sell securities to institutional investors. The NASD has illustrated its recognition of the deficiency in the current regime by introducing its rule proposal distinguishing suitability obligations relating to institutional investors from those relating to mom and pop.

But that proposal does not address the problem. The ability of institutional investors, as defined in this legislation, those responsible for investing at least $10 million in securities, to effectively guarantee, in effect, their unfortunate investment decisions by suing the broker or dealer based on an after-the-fact claim that the securities they bought were unsuitable, is a drain on our capital markets and is patently unfair and unprincipled.

Those institutional investors have not only the means but also the fiduciary obligation to invest the funds they manage with prudence, and that means that if that institutional investor does not have knowledge to make investment decisions himself, he should hire someone to do so. And with at least $10 million under management, he should have the resources to do that.

Some say that institutional investors charged with managing the public's money, such as municipal treasurers like Robert Citron, of Orange County, should not bear the burden of obtaining investment advice but should enjoy the effective guarantee provided by the suitability provisions of the current regime.

But it is especially incumbent upon those investors who manage the money that will be used to finance the building of schools and roads and paying policemen, of keeping our neighborhoods clean, to make adequately informed investment decisions. And if they do not have sufficient information on which to base those decisions, they should obtain it; if not from an investment advisor, then from the person selling the securities. And the liability for that advice should be clarified in a contract so all parties understand what risks they are undertaking and are compensated for accepting that risk.

We will hear more today about the subject of harmonizing and allocating more sensibly the roles of the Federal and State Govern-

ments in securities regulations. The North American Securities Administrators Association has acted expeditiously to address this vital issue since the introduction of the legislation, and I look forward to hearing the testimony of their new president today.

Since the introduction of the Federal-State securities regulation regime, our capital markets have undergone a dramatic transformation. Our markets are global, as well as local. Our regulations, however, have not kept pace.

Although State regulations have not added to the importance of uniformity, consistency and efficiency in the regulation of our capital markets, the patchwork they comprise is anything but uniform, consistent or efficient. Steps have been taken in the right direction, but the remarkable velocity and exponential growth of markets require more than just steps.

The States have demonstrated their importance to protecting investors against fraud, and they should not only continue but expand that role. The resources they now use in duplicating regulation that is already provided at the Federal level, or imposing substantive requirements that prevent the public from making their own investment decision, would be better spent on the cops on the beat.

And perhaps there are other areas in which the States' supportive role should be enhanced, such as in regulating the 22,000 investment advisors in this country. Ultimately, the goal of this legislation is to strike the best balance between protecting investors and enhancing the capital markets that our country's investors look to for their future. And I remain confident that we will achieve that balance by the concerted and complementary efforts of all the interested parties represented here today.

I look forward to the testimony of our distinguished witnesses on these and the numerous other issues on the table as we continue our consideration of the capital markets bill. I also look forward to working with my fellow members of the subcommittee, including my good friend ranking member Ed Markey, as well as Commerce Committee Chairman Bliley and ranking member John Dingell as we develop the legislation to transform our securities markets to better suit the evolving global markets of the 21st Century.

And with that, the Chair concludes his statement and would now recognize the distinguished ranking member from Massachusetts, Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

Today, the subcommittee continues its review of H.R. 2131, with witnesses representing some of the many industries that would be affected by this legislation, and I look forward to hearing from them.

I also look forward to working with you, Mr. Chairman, as we plan additional hearings next year to bring in a range of academic observers, market experts and other interested parties, such as public and private pension funds and other institutional investors, to develop the fullest possible factual record on the various needs of the marketplace.

This panel is an excellent one, and I congratulate you, Mr. Chairman, on the construction of today's set of witnesses.

As I indicated in our last hearing, the logical starting point to our ongoing review of this legislation is to assess the health of the market itself. On this score, the news is quite good.

By virtually every statistical measure, our capital markets are vibrant and healthy. Companies are raising record amounts of capital. The stock market is soaring to new records each week and we are in the midst of the largest merger and acquisition boom in history. With all this good news, it should come as no surprise that Wall Street's profits are expected to set new records for the second time in the last 3 years.

The question naturally arises: If the markets aren't broken, just what are we trying to fix? While even the healthiest of patients needs an occasional checkup, we must keep in mind that Congress can neither legislate continuous bull markets into existence, nor bar the inevitable bear markets from coming. Instead, our goal must be to assure fair markets that provide appropriate protection to investors so that our markets can continue to benefit from the very high degree of public confidence they currently enjoy.

You have noted, Mr. Chairman, that H.R. 2131 is a work in progress, and that significant revisions to the legislation will be made. I look forward to working with you on these revisions and on the suggested additions to this legislation I put forward at our last hearing.

As I have previously indicated, there are several concepts in H.R. 2131 which I am pleased to support, including the bill's efforts to boost the capital-raising abilities of small businesses and the grant of additional exemptive authority to the SEC. At the same time, I continue to have serious reservations about many other provisions in the bill.

I have heard no compelling reason why we should repeal the Trust Indenture Act, that protections that are given in that act for corporate bondholders affected by a default, this subcommittee substantially rewrote just 5 years ago in a bipartisan bill, by our then ranking Republican member and supported by the industry and unanimously by this committee and the Congress.

Moreover, instead of repealing the Williams Act, take over trip wire, I believe we should strengthen the Williams Act by reducing the reporting period for those who acquired 5 percent or more of the stock of a company, from the current 10 days down to 48 or 72 hours, because of the improvement in electronic technology. As Chairman Levitt testified last week, such a change would improve market efficiency and enhance investor protection.

On suitability, I have yet to hear a compelling case for reversing the course this subcommittee took 2 years ago, when we approved bipartisan legislation granting the NASD authority to issue suitability rules for the government securities market. Right now, the NASD rules that have been proposed, based on this grant of authority from Congress, are currently pending before the SEC.

I agree with Chairman Levitt, that there is no compelling rationale for short-circuiting this rulemaking in favor of new legislation which would abandon the historic presumption that brokers have ethical responsibilities to recommend suitable investments to their clients.

And finally, our dual system of State and Federal regulations seems to provoke great consternation among certain critics. The fact is that for most issuers, the dual regulatory system is largely irrelevant. The thousands of companies listed on the New York Stock Exchange, the American Stock Exchange, or NASDAQ's National Market System are entirely exempt from any independent State registration requirement. I have no doubt that we will be hearing a lot more about this issue at today's hearing.

I am hopeful, however, that these discussions will separate fact from fiction so that we can focus on how to improve the allocation and coordination of State and Federal regulation without losing any of the vital protections that both provide.

Let me close, Mr. Chairman, by again thanking you for undertaking this review of the health of the American capital markets. I welcome your invitation to work in the bipartisan spirit that has characterized so many of our efforts in recent years.

We, in turn, promise to work with you to assure that any legislation in this area is fair, comprehensive, balanced and responsive to the evolving needs of investors and the market as a whole.

I thank you, Mr. Chairman.

I yield back the balance of my time.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from New York, Mr. Manton.

Mr. MANTON. Thank you, Mr. Chairman.

At the outset, I want to thank you for holding this hearing today and for your efforts to examine the Nation's securities laws to see how they may be improved. These laws, many of which have been in place since the 1930's, should be reconsidered in light of the many changes that have taken place in the financial marketplace.

Clearly, changes can be made that will improve efficiency and remove some unnecessary regulatory burden thereby lowering costs and enhancing capital formation, without sacrificing strong consumer protections for investors. I am particularly concerned that during this process we continue to safeguard ordinary investors and that we maintain the trust that has developed in our markets.

While I do not support all of the elements of H.R. 2131, I believe that the bill provides a good opportunity to scrutinize and perhaps modernize the securities laws in some places. One area for possible action is in the division of responsibility between the Federal and State Government regulators. In these times of limited resources, I think we need to be especially careful to avoid duplication in regulation and identify the most appropriate level of government for each necessary function.

We may decide not to go as far as this bill suggests in limiting State regulatory controls, but it should be helpful to take a close look at the current system in our effort to improve it.

I do have some concerns about other provisions of the bill that will possibly compromise some investor protections and limit information disclosure, such as changes to margin requirements and elimination of the Williams Act. It is my hope that more information regarding these and other proposed changes will be made available through this hearing and an open legislative process that includes all stakeholders affected by this legislation.

I look forward to hearing the testimony today, and I yield back the balance of my time.

Mr. FIELDS. The gentleman yields back.

The gentleman from Pennsylvania, Mr. Klink.

Mr. KLINK. Thank you, Mr. Chairman.

I am pleased, again, that you are holding yet another hearing on H.R. 2131. I want to thank you for last week's hearing as well. I found it enlightening and informative to hear from Chairman Levitt and Chairman Greenspan that provided the Federal regulatory view of this bill. Their input I think is going to be very helpful when we work on a compromise version of this bill.

The input of State regulators I also think would be very helpful. And in that light, I would like to share some information with the Chairman and with the rest of the subcommittee provided by the Chairman of the Pennsylvania Securities Commission, Mr. Robert Lam. I have quoted Mr. Lam before in these hearings.

Chairman Lam provided me with a report on the types of security offerings that are the subject to State review. Chairman Lam makes several interesting points. Of all the corporate securities that were filed with the SEC from July 1994 to July 1995, only 5 percent, were subject to review by the Pennsylvania Securities Commission, 5 percent. Pennsylvania does have a reputation of being one of the more aggressive States, but again only reviewed 5 percent of the securities offered within a 1-year period.

If we take a worst-case scenario and double that figure, that would be up to 10 percent. That's not a big number in anyone's book, so why the outcry from the securities' industry about burdensome State regulation?

Pennsylvania automatically exempts securities listed on the New York, American or Philadelphia Stock Exchanges and the NASDAQ National Market System and will soon exempt securities listed on other exchanges. Based on this report, Mr. Chairman, the PSC reviews exactly the kinds of securities that should have close scrutiny; initial public offerings by startup or development-stage companies which most likely pose the most significant risks to public investors—in fact, one third of these offerings contained qualified opinions from accountants that cast doubt on the insurer's ability to continue as a going concern.

I ask for unanimous consent, Mr. Chairman, that Mr. Lam's report be made a part of the record for the members to review.

Mr. FIELDS. Without objection, so ordered.

[The information referred to follows:]

COMMONWEALTH OF PENNSYLVANIA
TOM RIDGE
Governor

ROBERT M. LAM
Chairman

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PENNSYLVANIA SECURITIES COMMISSION

DIVISION OF CORPORATION FINANCE

PRELIMINARY REPORT ON

CORPORATE EQUITY OFFERINGS FILED

UNDER SECTION 205 OF THE

PENNSYLVANIA SECURITIES ACT OF 1972

JULY 1, 1994 - JUNE 30, 1995

December 1, 1995

DISTRICT OFFICES
- 1109 STATE OFFICE BUILDING, PHILADELPHIA, PA 19130-4088, Telephone 215-560-2088
- 806 STATE OFFICE BUILDING, PITTSBURGH, PA 15222-1210, Telephone 412-565-5083

EXECUTIVE SUMMARY

1 **Review Limited to 133 Offerings.** Of the 2,639 registration statements for corporate equity securities filed with the U S Securities & Exchange Commission (SEC) during the period of this study (July 1, 1994 - June 30, 1995), only 133 (or 5% of all SEC filings) also were subject to review by the Pennsylvania Securities Commission (PSC).

2. **No Offering Underwritten by a National Brokerage or Investment Banking Firm Was Subject to Merit Review by the PSC.** All offerings filed by such firms during the period of this study withdrew the offerings to rely upon the self-executing exemption for securities listed or approved for listing upon notice of issuance on the New York, American or Philadelphia Stock Exchange or the NASDAQ National Market System. Merit review criteria were not applied to these offerings.

3 **Over 75%of the Offerings Subject to Merit Review were SB-2 and Regulation A Offerings with the SEC.** These filings represent primarily initial public offerings by start-up or development stage companies which most likely pose the most significant risks to public investors Nine offerings had underwriters which stated in the prospectus that they either had no previous experience as an underwriter or had very little experience.

4 **Offerings Subject to Merit Review Exhibited Substantive Regulatory Concerns.** Exactly one-third of these offerings contained a qualified opinion of independent accountants expressing doubt as the issuer's ability to continue as a "going concern". In over 25% of these offerings, the company asking the public to purchase its shares had loaned money to the company's principals which still was outstanding and owing at the time of filing with the PSC. In approximately 49% of these offerings, the company, as of its last full fiscal year, lost money. At least 16 companies had experienced losses since inception and 13 companies had received zero revenues from operations since inception.

5 **A Substantial Majority of Offerings Subject to Merit Review Raised the Issue of Escrow of Promotional Shares.** Two-thirds of the offerings contained substantial variances between the public offering price, the price paid by the promoters and the pre-offering value of the company By reasonably restricting for a finite period (usually within a range of 1-3 years depending on the offering and discussion with the company) the ability of the promoters to sell their cheap shares or to sell them at a price not below the public offering price prevents a depression in the market value of the public investors' shares and guards against promoters making a "quick profit" at the expense of the public. To save companies the cost of a formal escrow, the PSC accepts a standard agreement between the affected shareholders and the company which recites the restrictions (Lock-in Agreement) In every offering which withdrew as a result of staff comments, a request had been made for a "Lock-in" of promotional shares.

6. **Merit Review does not Impede International Offerings.** Only three of the 133 offerings were by foreign issuers Two were registered and one currently is under review

PRELIMINARY REPORT ON CORPORATE EQUITY OFFERINGS FILED UNDER SECTION 205 OF THE PENNSYLVANIA SECURITIES ACT OF 1972 FOR FY1994-95

I. **Section 205 of the Pennsylvania Securities Act of 1972.**

Under Section 205 of the Pennsylvania Securities Act of 1972 (1972 Act), any security for which a registration statement has been filed with the SEC under the

Securities Act of 1933 or any proposed sale pursuant to Regulation A promulgated under section 3(b) of the 1933 Act may be registered by coordination in Pennsylvania. Filing with the PSC is made by using SEC documents, paying a fee and submitting a uniform application form prior to SEC effectiveness.

II. Statutory Standard of Review

Section 208(a)(v) of the 1972 Act states that the PSC may issue an order denying effectiveness to, or suspending or revoking the effectiveness of, any registration statement if it finds that the order is in the public interest and the offering has been or would be made with ***"unreasonable amounts of underwriters' and sellers' discounts, commission or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options or has worked or tended to work a fraud upon purchasers or would so operate . . ."*** (emphasis added). This often is referred to as "Merit Review".

Under Section 207(g) of the 1972 Act, the PSC also is authorized to require, under certain circumstances and as a condition of registration by coordination, that any security issued within the past two years or to be issued to a promoter for consideration substantially different from the public offering price, or to any person for consideration other than cash, be deposited in escrow It further authorizes that the PSC may require that the proceeds form the sale of the registered security be escrowed until the issuer receives a specified amount from the sale of the security.

For an offering registered by coordination, where more than two-thirds of the securities will be sold in Pennsylvania, the PSC may require, as a condition of registration, a report by an accountant, engineer, appraiser or other professional person.

III. Legislative Findings Concerning Statutory Review Standards

Prior to 1972, Pennsylvania securities laws did not require registration of securities. In the 1960s, a large number of Pennsylvania investors were ripped off in investment scams operated by promoters who raised money solely to pay themselves huge salaries and expenses. Typically, a promoter would start a company and sell shares to the public. At that time, fast food restaurant concepts were a "hot" market. After issuing shares to himself for little or no money, the promoter would sell shares to the public, often taking a sales commission on each purchase. The proceeds would be used immediately to pay the promoter a salary and expenses with little left over for legitimate business activities. When sales began to slack, the promoter would find a buyer for his cheap stock and then flee the jurisdiction, leaving the public investors with shares in a worthless company.

Responding to thousands of investor complaints and the loss of millions of investor dollars as well as the potential damage to its commercial reputation, the Pennsylvania General Assembly held hearings around the Commonwealth in the early 1970s. The General Assembly also consulted the practicing Securities Bar in Pennsylvania. The result of these hearings and deliberations was passage of the 1972 Act which included, for the first time, a securities registration requirement. The 1972 Act, however, also contained a number of exemptions from registration for securities and securities transactions for which registration was not deemed necessary or appropriate for the protection of investors.

One the exemptions established by the General Assembly was for securities listed or approved for listing upon notice of issuance on the New York, American or Philadelphia Stock Exchange. The same section now applies to securities quoted

on the NASDAQ National Market System. Based upon compliance with the Uniform Memorandum of Understanding on Exchange Listed Securities promulgated by the North American Securities Administrators Association, the PSC expects shortly to bring securities listed on the Pacific Stock Exchange and the Chicago Board Options Exchange within the provisions of this exemption.

Based upon the events leading to enactment of the 1972 Act, the General Assembly wanted the PSC to have the authority to curb in the future the unreasonable promoters' profits that had been gained at the expense of the public investor. Specifically, it was concerned that promoters who purchased their shares for little or no money should not be allowed to large amounts of them, reap a huge profit and then walk away from the company. Not only did this practice depress the market for the shares held by the public, but it also left the company without management. This led eventually to bankruptcy and a complete loss of value in the shares purchased by the public investors. Therefore, the PSC was granted the authority in appropriate circumstances to require an escrow of promoters' cheap shares.

Also considered a form of promoters' profits by the General Assembly were "sweetheart" deals arranged by the promoter with the company whereby the promoter would benefit personally at the expense of the company and the public shareholders even if the company did not perform well. Examples of such transactions would be loans made by the company to promoters and principals (for home mortgages or personal items) at very favorable rates, payments of royalties or license fees from gross sales where the promoter would make money even if the company was operating at a loss, and exclusive vending or lease arrangements with promoters or their relatives.

The General Assembly also was concerned with the tactic that promoters immediately would use the proceeds from the sale of the securities even though a certain minimum amount needed to be raised in order for the company to be capitalized sufficiently for the business in which it was to be engaged. The danger was that the public investor would make an investment decision not knowing that the issuer needed a certain minimum amount of capital to make the enterprise viable and that, without sufficient additional sales, the investment could turn out to be worthless.

Further, the General Assembly was concerned about offerings where material information necessary for a reasonable investor to make an informed investment decision was not disclosed at the time of purchase. Therefore, it granted the PSC authority to deny a registration statement that would tend to work a fraud or would so operate. Most registration statements filed under Section 205 follow SEC disclosure guidelines but the PSC has seen significant disclosure issues arise in the context of Regulation A offerings. In a recent Regulation A offering, SEC staff sent a Pennsylvania issuer a two page disclosure comment letter while PSC staff, having significant knowledge of the prior business activities of the issuer, sent a 14 page letter suggesting that the issuer had omitted to include significant material facts in the offering circular.

IV. Implementation of Statutory Standards of Review

To implement the statutory standards of review adopted by the General Assembly in the 1972 Act, the PSC has published guidelines for the review of corporate equity offerings (Guidelines). These Guidelines appear in the PSC's ***Compendium of the 1972 Act*** which has over 200 subscribers and is updated semi-annually.

These Guidelines serve as a guidepost so companies know in advance what issues may present a regulatory concern to the PSC under the statutory review standards established by the General Assembly in the 1972 Act. The Guidelines are not rigid

or inflexible. Each offering is unique and the review is based upon the totality of the offering and not necessarily on the basis of any single component.

As the Guidelines implement the statutory review criteria, they address the various forms in which promoters may attempt to gain an advantage over public investors who have provided the company with the majority of its capital in which there is no correlation between the advantage sought and the success of the company. For instance, public investors should not have their money used to subsidize the making of loans by the company to its principals, except for bona fide business purposes (*e.g.* relocation expenses). Of the companies included in this study that were subject to PSC review, over 25% had loans outstanding to principals at the time of the offering. Neither should the public's money be used to pay for exclusive supply contracts or leases with company principals or their relatives unless the terms are as favorable as could be obtained from independent third parties and it is in the best interest of the company to engage in such business relationships.

The more obvious form of promoters' profits or participation is the cheap stock held by promoters. This is stock which was issued for little or no money and generally in consideration of the efforts expended by the promoter in organizing and founding the company. Of the offerings reviewed in this study, it is interesting to note that 10% of all companies subject to PSC review had issued cheap stock to their promoters even though they were total start-up enterprises that had no revenues.

The focal issue is the relationship between the price paid for the cheap stock, the current value of the company and the price which the public investors are being asked to pay. If a promoter paid $.01 per share and the current value of the company prior to the offering is $.05 per share (based on net tangible book value) and the public offering price is $5.00 per share, the public investor is being asked to pay 500x what the promoter paid and 100x the current value of the company. When the company has a negative net worth, these ratios increase dramatically. Of the companies included in this study that were subject to PSC review, 50 had a pre-offering negative net worth based on net tangible book value.

To curb unreasonable promoters' profits which might occur if a promoter sells large amounts of his cheap shares into the market after an initial public offering, thereby depressing the market value of the shares purchased by public investors, an escrow of promotional shares or agreement not to sell such shares or not to sell them below the public offering price for a certain period of time is necessary to protect the public investor. Underwriting agreements usually call for similar restrictions but they are for lesser time periods (180 days) that can be shortened significantly upon consent of the underwriter, which consent may not be reported to the market which often causes an unexplained "slump" in the market price of the company's securities (*see* Power, W., "A Tale of a Trendy New Stock's Mysterious Slump", ***Wall Street Journal***, July 20, 1993). Of the companies included in this study that were subject to PSC review, 89 were requested to enter into a Lock-in Agreement concerning cheap stock.

V. Statistical Information and Policy Recommendation

The attached statistical information covers filings made with the PSC during the period July 1, 1994 - June 30, 1995 for offerings of corporate equity securities which were filed under Section 205 of the 1972 Act. Section 205 is the registration by coordination provision which facilitates the review of offerings that also are filed with the U.S. Securities and Exchange Commission pursuant to the federal Securities Act of 1933 (1933 Act).

The provisions of state securities laws providing for substantive review of certain offerings predated enactment of the 1933 Act. In passing the 1933 Act, Congress decided not to duplicate state review at the federal level Because one of the most important features of the federal securities laws was the ability to prosecute securities frauds without regard to state lines, the disclosure only requirements of the 1933 Act were entirely suitable. Omissions of material facts or misstatements of material facts in SEC filed documents giving rise to securities fraud was the only standard that really was necessary, from the federal point of view, to bring a SEC securities fraud enforcement action.

With securities listed on national securities exchanges exempt from review at the state level because those markets were monitored by the SEC under the Securities Exchange Act of 1934, states were left with what was seen as their proper role of reviewing, in a more substantive manner, those unseasoned companies that were attempting to sell securities to the public for the first time. With the expansion of state exemptions for securities listed on regional securities exchanges and the NASDAQ National Market System, the states still are fulfilling a well-defined and focused role in providing appropriate standards of investor protection without placing undue burdens on capital formation.

As the statistical information points out, over 75% of all filings subject to PSC review are filed on SEC Form SB-2 or under Regulation A. To use Form SB-2, the issuer must be a small business with revenues of less than $25 million. As indicated previously, 13 such companies which were subject to PSC review had zero revenues. To use Regulation A, the issuer cannot offer more than $5 million in securities nor be subject to certain disqualification provisions in SEC Rule 262. Based on figures for calendar year 1994, Regulation A and Form SB-2 filings accounted for only 17% of the total registration statements filed with the SEC.

Given that the majority of PSC review is devoted to Regulation A and Form SB-2 filings, which represent a very small portion of all SEC registration statements, and that the SEC's budget most likely will be reduced, perhaps the SEC should delegate exclusive review authority over Regulation A and SB-2 offerings to the states.

STATISTICAL INFORMATION

CORPORATE EQUITY FILINGS[1]
July 1, 1994 - June 30, 1995

A. Comparison of Registration Statements Filed with the SEC and Pennsylvania

Total registration statements filed with the SEC:	2,639
Total registration statements filed with Pennsylvania:	**193**

B. Filings Subject to PSC Review under Section 205 of the 1972 Act

Total files received	193
Files withdrawn to rely on Exchange Exemption[2]:	(32)
Files abandoned by the issuer:	(3)
Files voluntarily withdrawn by issuer, *e.g.* to rely on an exemption; terminated; withdrawn from SEC:	(25)
Total files subject to PSC review[3]:	**133**

C. Profile of Status of Filings Subject to PSC Review

Filings registered	50
Filings currently under review	25
Filings withdrawn as a result of staff comments	58
TOTAL	133

[1]Excludes mergers filed on Form S-4. This exclusion mirrors exclusions made in statistical reports prepared by the SEC Division of Corporation Finance.

[2]These issuers filed a copy of their SEC registration statement in order to make offers in Pennsylvania, usually by means of a "red herring" prospectus. Upon approval for listing on the New York, American or Philadelphia Stock Exchange or qualification for designation on the NASDAQ National Market System, the issuer withdrew from Pennsylvania in reliance on the self-executing Exchange Exemption in Section 202(f) of the 1972 Act. Consequently, no merit review standards were applied to these offerings.

[3]The statutory review standards set forth in the 1972 Act were applied to these offerings.

D. Profile of Underwriters of Offerings Filed with the PSC

	W/D Exchange Exempt.	W/D Vol.	Aband.	Full Review
Nat'l Retail U/W	1[4]	0	0	0
Nat'l Invest. Firm	8[5]	0	0	0
Regional U/Ws	13[6]	0	0	2[7]
Other U/Ws	10[8]	18[9]	2	126[10]
Self-U/W (Issuers)	0	7	1	5

[4]Offering underwritten by Smith Barney.

[5]Offerings were underwritten by CS First Boston, Morgan Stanley, Lehman Brothers, Lazard Freres and Donaldson Lufkin & Jenrette.

[6]Offerings were underwritten by Hambrecht & Quist, Alex Brown & Sons, McDonald & Co., Janney Montgomery Scott and Dain Bosworth.

[7]Offerings were underwritten by Legg Mason Wood Walker.

[8]Offerings were underwritten by Marleau Lemire, H.J. Meyers, Hampshire Securities, J.C. Bradford, Volpe Welty, Furman Selz, Richardson Greenfield, Rickel & Assoc. and White Rock Partners.

[9]Offerings were underwritten by Strasberger Person Tukin, M.H. Meyerson, Stamford Capital, GKN Securities, Nichols Sofina Lerner, Landmark Int'l., Spelman & Co., Cohig & Assoc., Meridian Dunhill, Joseph Stevens, Kemper Securities, Paulson Investments, Fin-Atlantic Securities, Duke & Co., H.J. Meyers, Coleman & Co. Securities, and Gaines Berland.

[10]Offerings were underwritten by Schneider Securities, J.C. Bradford, Rodman & Renshaw, GKN Securities, Barrington Capital, Meyers Pollock Robbins, Sterling Foster, Trident Securities, Richter & Co., Thomas James, Royce Investment Group, Miller Johnson & Kuehn, Progressive Asset Management, Paragon Capital, J. Michael Reisert, Fin-Atlantic Securities, Midwood Securities, Investment Bank Services, RAS Securities, Laidlaw Equities, Charles Webb, Cohig & Assoc., Taglich Bros., Harriman Group, D.H. Blair, Westfield Financial, Paulson Investments, W.B. McKee Securities, Comprehensive Capital Corp., La Jolla Securities, Barron Chase, Gilford Securities, Equitable Securities, Joseph Stevens, Dickinson & Co., Baird/Mark Capital Corp., Maidstone Financial, Coleman & Co., First Allied Securities, A.S. Goldmen, Joseph Roberts, John G. Kinnard, Hanover Sterling, Brookehill Equities, J.W. Charles, Southeast Research Partners, Auerbach Pollack & Richardson, Patterson Travis; Texas Capital Securities, Norfolk Securities, Baraban Securities, Network 1 Financial, Argent Securities, Redstone Securities, Sentra Securities, Berkeley Securities, Werbel-Roth Securities, Toluca Pacific Securities, L.C. Wegard & Co., Keane Securities, Potomac Securities, Josephthal Lyon & Ross, Friedman Billings Ramsey & Co., Whale Securities, First Equity of Florida Securities, A.T. Brod, Janssen Meyers and S.D. Cohen & Co.

E. Profile of Substantive Characteristics of Filings Subject to PSC Review

Characteristic	Registered	Withdrawn	Under Rev.	Total	% of Total
Qualified Audit Ltr.[11]	5	27	12	44	33%
Losses[12]	12	41	12	65	49%
Loans Outstanding[13]	13	10	7	30	26%
Lock-in of Promotional Shares[14]	9	58	22	89	67%

[11]The offering contained a qualified opinion of independent auditors expressing doubt as to the issuer's ability to continue as a "going concern".

[12]As of its last full fiscal year, the issuer had a negative net income. At least 16 issuers had losses since inception of the company. At least 13 issuers had received zero revenues from operations since inception.

[13]At the time the offering was filed, there existed loans outstanding from the company to the officers, directors or promoters. When the review comment was given requesting a representation that these loans would be repaid to the company by the close of the offering and that the issuer would represent that future loans would be made only for bona fide business reasons, 13 companies submitted such representations and were registered while 10 elected not to do so and withdrew their offerings.

[14]Due to the substantial difference between the price paid for the promoters' shares and the proposed offering price to the public as well as the current net worth of the company as expressed by its net tangible book value, a review comment was made

requesting a Lockin-in Agreement whereby the promotional shares would not be sold for a specific period or not below the public offering price. This restriction usually ranges from 1-3 years depending on the offering and discussions with the company. Where it was appropriate to give this review comment, agreement was reached with nine companies whose offerings were registered while 58 companies elected to withdraw their offerings. Of these 58 companies, the average net tangible book value prior to the offering was (\$.23)/share, the average price paid by the promoter was \$.04/share and the average offering price to the public was \$6.76/share

F. Profile of Financial Characteristics of Filings Subject to PSC Review

Characteristic	Registered	Withdrawn	Under Rev.	Total
Avg. Per Share Net Tangible Book Value[15]	\$1.10	(\$.23)	\$.19	\$.36
Avg. Price Per Share Paid by Promoters[16]	\$1.22	\$ 16	\$.04	\$.53
Avg. Per Share Public Offering Price[17]	\$8.34	\$5.60	\$6.31	\$6.76

[15]At the time the filing was made with the PSC, this figure represented the net worth or current value of the company on a per share basis.

[16]This represents the average price paid for shares currently held by the promoters of the company. The current value of these shares is reflected in the net tangible book value of the company.

[17]This represents that per share price at which the securities will be offered to the public.

G. Profile of Registration Statements Subject to PSC Review

Type of Reg Stmnt	Registered	Withdrawn	Under Rev	Total	%of Total
SB-2[18]	27	48	18	93	70%
Regulation A[19]	2	3	2	6	5%
S-1	14	7	4	25	19%
S-2	3	1	0	4	3%
S-3	2	0	0	2	1%
F-1[20]	2	0	1	3	2%

H. Offerings by Foreign Issuers

During the period covered by this study, only three corporate equity offerings were filed under Section 205 of the 1972 Act by foreign issuers which were subject to PSC review Two were registered and one currently is under review. There were 117 offerings, however, which were filed with the PSC by issuers located in 23 separate foreign jurisdictions totalling over $10 billion. These represented debt offerings, private placements, employe stock option plans, sales to exisiting security holders, etc.

Those offerings involving the offer and sale of corporate equity securities were accommodated under existing exemptions from registration set forth in the 1972 Act. Merit review criteria were not applied to these exempt transactions. The exemptive provisions governing securities issued by foreign issuers is exactly the same as governs domestic issuers so that a Pennsylvania issuer is not disadvantaged due to a preference given a foreign issuer.

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[18]To use Form SB-2, the issuer must be a small business with revenues of less than $25 million.

[19]To use Regulation A, the issuer cannot offer more than $5 million in securities nor be subject to certain disqualification provisions in SEC Rule 262.

[20]These offerings were by foreign issuers Two were Canadian and one was located in the United Kingdom.

Mr. KLINK. Thank you, Mr. Chairman.

Finally, I thank you again for scheduling the testimony of Mr. Harris today. I only wish he were testifying earlier in the day. I fear that when this panel is on at 3 or so this afternoon, that the room may not be as full as it is right now.

Mr. Chairman, as you know, I continue to have some serious reservations about the legislation. However, I will say the way in which you have conducted these hearings has alleviated many of my concerns. We have had the opportunity to get a lot of information. I look forward to today's testimony and to working with you on this bill in the days and weeks ahead.

I yield back my time.

Mr. FIELDS. The gentleman's time has expired. The Chair appreciates his statement.

Mr. FIELDS. The gentlelady from California, Ms. Eshoo.

Ms. ESHOO. Good morning.

Thank you, Mr. Chairman. I don't have an opening statement.

I would just like to add my voice to those of my colleagues in thanking you for having several hearings on this bill. We are enlightened by those that come before us on the different parts of it. So thank you.

Mr. MARKEY. Would the gentleman yield?

Mr. FIELDS. Be glad to yield.

Mr. MARKEY. I have an opening statement here from the gentleman from Illinois, Mr. Rush, that he would like to have inserted in the record at this point, with other materials which he has.

Mr. FIELDS. Without objection.

[The prepared statement of Mr. Rush follows:]

PREPARED STATEMENT OF HON. BOBBY L. RUSH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. Chairman, I want to thank you for holding this series of hearings on H.R. 2131. I know that there has been a great amount of concern expressed about this legislation and I am pleased that you have indicated that this is a "work in progress."

There is one area that I would like to be sure is addressed as this bill is modified. The bill as it is currently written, will effectively repeal a significant portion of the Government Securities Act Amendment of 1993. This act among other things, was intended to help many state and local jurisdictions, that cannot afford highly skilled investment experts, to manage their pension funds on behalf of hard working taxpayers.

I have received letters from associations and individual representatives of these state and local governments. They are concerned with the provisions of the bill that would eliminate the suitability obligation of broker/dealers to these organizations. I would ask that a letter from the Policemen's Annuity and Benefit Fund of the City of Chicago be entered into the record.

In testimony given last week by Chairman Levitt of the Securities and Exchange Commission, he indicated that a relaxation of the suitability obligation is "an area not ripe for legislation," and that the SEC is currently in the process of a rule making on this very issue.

Today's witnesses will provide the Subcommittee with valuable insight on this issue. If this legislation is left as written, how will it effect the safety of taxpayer money with the presumption that broker/dealers are not liable for their investment recommendations?

We also need to clarify for the record who these "institutional" investors are. The word "institutional" makes us think that are talking about very sophisticated investors like mutual funds, pension funds, or insurance companies. I understand under this bill "institutional" investors can be local governments, charitable foundations, public school districts and religious institutions.

There are many questions that must be asked about the risks involved in eliminating these critical suitability obligations. We must provide for a confident relationship between our institutional investors and broker/dealers. I am looking forward to learning from those in industry if it makes sense to legislate at this time or let the Securities and Exchange Commission promulgate a rule making and see if the process is the best for protecting investors.

I yield back the balance of my time.

Mr. FIELDS. The Chair would now like to turn to the first panel. The Chair would ask that our witnesses keep their remarks to 5 minutes. Your remarks will be put in the record in their entirety. There may be additional questions that members will have that will be submitted in writing.

Mr. Krongard, let us begin with you, Mr. A.B. Krongard representing the Securities Industry Association.

STATEMENTS OF A.B. KRONGARD, CHAIRMAN, SECURITIES INDUSTRY ASSOCIATION; ELAINE LaROCHE, VICE-CHAIR, PUBLIC SECURITIES ASSOCIATION; JOHN GAINE, GENERAL COUNSEL, MANAGED FUTURES ASSOCIATION; MATTHEW P. FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE; R. CHARLES SHUFELDT, REPRESENTING AMERICAN BANKERS ASSOCIATION; AND STEPHEN FRIEDMAN, PARTNER, DEBEVOISE & PLIMPTON

Mr. KRONGARD. Thank you, Mr. Chairman.

I am A.B. Krongard, Chairman of the Securities Industry Association. SIA and its more than 750 members play a vital role in capital formation, conducting more than 90 percent of the securities business in the United States.

SIA's members have created these capital markets, equity, debt, both public and private, financial futures, options, OTC derivatives and others that are the world's envy. SIA members have a fun-

damental interest in serving the needs of all clients, investors as well as issuers of securities. By finding ways to make our markets more efficient and to lower the costs of raising capital, everyone wins: Investors, companies, the securities industry and the national economy.

Our securities markets have long set the world standard for integrity, liquidity, innovation and dynamism. However, today, there is keen global competition for capital among many markets around the world. Our Nation can only maintain its current strong position if our markets and our regulatory structure are as fair and efficient as possible.

These concerns require a legislative response that preserves policy objectives of the Federal securities laws, while eliminating those provisions that have become hindrances to the markets and ultimately to issuers or investors. H.R. 2131, introduced by Chairman Fields, is just such a legislative response.

SIA's board of directors voted unanimously to support this bill. Chairman Fields, SIA pledges our support in moving this legislation to passage.

We support this bill for many reasons, but we express particularly strong support for the provisions dealing with institutional suitability, dual State-Federal regulation, margin, SEC exemptive authority and coordination among SRO examiners. Among the strongest reasons why SIA supports this bill is the need to address the confusing multiplicity of 50 separate State regulatory requirements that make America's capital market regulatory structure unduly complex. The Fields' bill would mark the first comprehensive review in 60 years to rationalize dual Federal and State jurisdiction over the securities markets.

As the securities markets have developed, State regulation has become part of a much more complex regulatory structure. The securities industry is subject to layers of oversight and regulation, the SEC, SROs and separate regulatory schemes of 50 States. The firms themselves also have substantial responsibilities in policing themselves.

The evolution of self-regulatory organizations, changes in market structure and other developments have reduced the rationale supporting State securities regulation. Many State requirements unduly burden the markets and raise the cost of capital, and some State requirements impair investor opportunities. In contrast, other major industrialized nations typically apply one single set of national standards or even multinational standards to their capital markets.

To illustrate how inefficient the current dual Federal-State regulatory approach is, imagine what airline passengers would face if in addition to Federal regulation every State over which a commercial plane flew on its way from New York to California had its own distinct technical requirements. New Jersey might require mandatory use of oxygen masks in flight. Ohio and Kansas might require that the plane land for State inspections. And even if air travel was made incrementally safer by some State requirements, it is doubtful that the traveling public would be well-served. Yet, this is a fair analogy to the current system of dual Federal and State regulation of brokers.

The bill preserves a State role in securities regulation but delineates that role much more sensibly than does current law. Among other things, States can still require securities professionals to register with them. The ability of States to police against fraud is preserved. I particularly emphasize that SIA strongly supports this and applauds the significant achievements of State regulators in this regard. Also, States can still collect the same fees from participants.

The significant change that the bill makes to State regulation is simply this: It prevents States from establishing inconsistent regulatory requirements in areas that are already regulated by the SEC. For example, States can continue to require State registration of security professionals and their firms, but State requirements must be consistent with national requirements established by the SEC and NASD.

States would no longer regulate mutual funds which are comprehensively regulated at the Federal level and which included both disclosure and merit review. The bill would codify in Federal law the current practice among nearly all States of exempting the securities of blue chip companies from State regulatory requirements and prevent them from opting out or imposing burdensome add-ons which are not relevant to the financial risks of the security.

Section 2 of H.R. 2131 is a reasonable solution to the problems that arise when suitability principles developed for the retail market are applied on a blanket basis to institutions. The securities industry has long recognized that a broker that recommends an investment to a retail customer must have a reasonable basis to believe that the investment is appropriate to that customer's circumstances and objectives.

However, in the case of an institutional client, the presumption and the pricing in our industry is the opposite; that the client is making its own decisions and relying on its own sources of advice. The institutions will have formulated an investment strategy with one component being risk tolerance. For a broker to attempt to make its own determination concerning whether any particular trade is suitable would require the broker to undertake a continuing evaluation of an institution's entire strategy within a virtual timeframe.

Few institutions want or need this type of second-guessing from the broker who executes their trade. None would want the delays it entails.

Thank you.

[The prepared statement of A.B. Krongard follows:]

PREPARED STATEMENT OF A.B. KRONGARD, CHAIRMAN, SECURITIES INDUSTRY ASSOCIATION

INTRODUCTION

Mr. Chairman, Members of the Subcommittee: The Securities Industry Association ("SIA")[1] appreciates this opportunity to present its views on the need to mod-

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[1] The Securities Industry Association is the trade association representing over 700 securities firms throughout North America. Its members include securities organizations of all types—investment banks, brokers, dealers, specialists, and mutual fund companies. SIA members are ac-

Continued

ernize regulation of the Nation's capital markets and to express our strong support for The Capital Markets Deregulation and Liberalization Act (HR 2131). I am A.B. Krongard, Chairman of SIA. The members of SIA play a vital role in the capital formation process and in the operation of our Nation's secondary trading markets. For more than 200 years the U.S. securities industry has acted as an intermediary between the suppliers of funds and those who need capital.

SIA members have created these capital markets—equity, debt (both public and private), financial futures, options, OTC derivatives and others—that are the world's envy. SIA members serve as intermediaries between investors and issuers of securities, and so our members have a fundamental interest in serving the needs of both sets of clients. By finding ways to make our markets more efficient and lowering the cost of raising capital, everyone wins—investors, companies, and the securities industry itself.

Our securities markets have long been the best in the world, and set the world standard for integrity, liquidity, innovation and dynamism. They have attained this position in part because of an intelligent federal regulatory system. Like any human endeavor, however, this complex regulatory system requires regular maintenance and an occasional overhaul by its stewards. Changing times and circumstances have made some rules and statutes obsolete, creating needless hindrances to economic growth and competitiveness. The securities industry is subject to a remarkable number of layers of oversight and regulation—the SEC and other federal agencies, the rules of self-regulatory organizations ("SROs"), and separate regulatory schemes of 52 state and territorial entities. We therefore believe we have some insights to share with the Subcommittee on where value can be added to the regulatory structure as Congress considers how to "re-engineer" securities regulation.

These concerns require a legislative response that preserves policy objectives of the federal securities laws, while identifying and improving those provisions that have become hindrances to the markets, and ultimately to issuers or investors. HR 2131, introduced by Chairman Fields, is just such a legislative response. SIA's Board of Directors voted unanimously to support the bill. Chairman Fields, SIA is proud to pledge our support in moving this legislation to passage. This testimony will address the need to reexamine the framework of federal securities regulation generally, and SIA's views on the key proposals contained in HR 2131.

I. THE IMPACT OF THE CAPITAL MARKETS REVOLUTION

The United States has the largest and most vigorous securities markets in the world. Our markets are a tremendous national resource, affecting all areas of the U.S. economy, providing low-cost capital to business and government, and creating new opportunities for private and public investors. While the securities industry's tradition of creativity and leadership originates from before the creation of the New York Stock Exchange in 1792, it is important to recognize that our markets have grown and prospered under the federal securities regulatory regime adopted during the New Deal. For example, since World War II equity market capitalization has grown 75-fold, from $100 billion in 1945 to $7.4 trillion last year, while total outstanding government and corporate debt instruments burgeoned from $294 billion to $9.6 trillion, nearly a 32-fold increase. Today U.S. households hold $10 trillion in liquid financial assets, two-thirds of which are invested in capital markets products. Millions more people from around the world also invest in American jobs and economic growth through our capital markets. Foreign investors' transactions in U.S. securities grew from $1.4 billion in 1945 to $6.6 trillion in 1994, more than a 4,000-fold increase.

The Securities and Exchange Commission ("SEC") has succinctly described the reasons why both Congress and the SEC need to reassess carefully the entire regulatory structure of our capital markets. The SEC noted in a recent proposal that it recognizes the need to reexamine regulations because of "significant changes in the structure of the markets, including the expanded role of institutional participants, new kinds of trading instruments and strategies, enhanced transparency of securities transactions, expanded surveillance capabilities, globalization of the markets, and transformation of the capital-raising process." [2] Those same factors warrant both a top-to-bottom review of SEC regulations, which the SEC is now conducting, and of the statutory framework underlying our securities markets. Before I ad-

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tive in all markets, and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of investment services and account for approximately 90% of the securities business conducted in the U.S.

[2] "Review of Antimanipulation Regulation of Securities Offerings." SEC Release Nos. 33-7057; 34-33924 (April 19, 1994).

dress the specifics of your bill, Mr. Chairman, I will discuss briefly a few aspects of the markets' transformation that make regulatory redesign both timely and essential to the future of America's securities markets.

Technology. Technology is the driving force of change and opportunity in the securities industry. Computers, modems and sophisticated telecommunications systems have created previously unimaginable efficiencies and opportunities in the markets. These technologies lie behind the ability of the New York Stock Exchange to handle an average daily volume of 338 million shares, compared to 6 million shares 30 years ago. New types of markets, such as Nasdaq, have flourished in large part because they took advantage of technological advances in computers and telecommunications. Technology has helped our industry improve efficiency, handle increased volume, provide new products and services, and expand information gathering and storage capabilities. It has also greatly increased the choices for the financial services consumer. The Internet and the many on-line services are opening up many other fascinating opportunities for individual investors to buy and sell stocks, get price quotes on securities, and check the value of their portfolio.

Risk Management. These developments in technology have helped make possible new financial instruments to help companies and fund managers better manage risks, such as interest rate and currency fluctuations. This has helped American companies to compete in foreign markets, and has made it easier for American mutual funds and pension funds to manage risk and maximize investment opportunities for millions of Americans. The development of modern risk management techniques raises legitimate questions about the continued need for certain aspects of federal margin requirements and whether inflexible margin requirements needlessly hamper the ability of U.S. securities firms to compete effectively internationally and with other financial service providers. I will address these issues later in my statement.

Internationalization. These technologies have linked American capital markets with other markets around the world. Access to foreign markets benefits the U.S. economy by providing new savings pools, reducing capital costs, furnishing new investment opportunities and increasing U.S. employment. Since the end of the Cold War, many countries have moved toward political and economic systems that encourage open, market-oriented economies. As this trend continues, both developed and developing markets are seeking ways to enhance their international competitiveness, creating tremendous global demand for capital—the life blood of economic growth and job creation in any economy.

Despite these innovations and the continuing success of the U.S. capital markets, the U.S. share of the world's equity market capitalization has declined from 58 per cent in 1974 to 33 per cent last year, as illustrated by the chart attached to this testimony.[3] Because the U.S. capital markets compete with expanding foreign markets, regulations or policies which limit the efficiency of our market will give the world's pool of capital another reason to seek new markets. In short, the pie has grown much larger, but other nations hungry for capital are taking a much larger share, and the future preeminence of the United States is not guaranteed.

The Need for Balance. In the face of this intense global competition for capital, it is critically important to constantly seek the correct balance in regulating our securities markets. Every day billions of dollars of transactions clear and settle on the stock exchanges and in the debt markets based on a handshake, a nod, a hand signal, or a phone call. This would not be possible without the public's overwhelming confidence in the U.S. capital markets and the securities industry. Confidence depends on the belief that the markets operate with complete integrity so that every participant plays by the same rules. If investors lose this confidence, their money may stay under the proverbial mattress.

On the other hand, if regulations are needlessly complex or burdensome, capital will flow to markets with more rational regulatory schemes. America has been fortunate to have a federal securities regulatory scheme over the past six decades that has worked extremely well. The SEC and our self regulatory organizations have been emulated by nations all over the world. However, success can breed complacency. History shows that there is very little margin for error in regulating the capital markets, as over-regulation can stifle growth.

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[3] *See* Exhibit A. The position of the United States among global capital markets is still very strong, considering that U.S. Gross Domestic Product, garners "only" about 23% of world GDP and the U.S. population is less than 5 per cent of the world's total.

II. MODERNIZING SECURITIES REGULATION FOR THE TWENTY-FIRST CENTURY.

Like most legislative acts, a number of provisions of the federal securities laws were initially drafted in the early 1930s to accommodate the political and market realities of that day. In many instances, such accommodations have become outdated. Chairman Fields deserves praise for calling attention to several statutory anachronisms that need to be reexamined in light of market conditions that are vastly different from sixty years ago. Provisions that have outlived their usefulness need to be discarded or recast to ensure that America's capital markets provide the same benefits to our economy in the 21st century that they have provided in this century. This section of my testimony will address the issues implicated by the five provisions that make up the heart of HR 2131: creation of national securities markets; investment recommendations to institutional clients; securities margin requirements; SEC exemptive authority; and designation of primary SRO examining authorities.

A. Untangling the Web of State Securities Regulation.

One of the most fundamental statutory inefficiencies within the federal securities laws is the largely uncoordinated relationship between federal and state jurisdiction over the securities markets. When the first federal securities laws were enacted, many states had already adopted their own securities regulations. These "blue sky" laws generally imposed a highly paternalistic system of "merit" regulation, in which a state administrator determined whether the price and circumstances of a particular securities offering was "fair" to the investors living in that state. On the other hand, the first federal securities law, the Securities Act of 1933 ("Securities Act"), was based on a radically different philosophy—full disclosure. This approach is premised on the view aptly summarized by Justice Louis D. Brandeis: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[4] In other words, if the market has full and complete access to information about companies that offer securities, the marketplace itself will determine a fair price for securities, and will reward or punish companies based on their economic performance, rather than on their ability to meet standards set by a regulator.

Despite this departure from the preexisting regulatory approach of many states, the Securities Act and subsequent federal securities laws contain an anomaly that keeps the door open to "merit" regulation: language expressly preserving state blue sky laws from federal preemption. A report by the American Bar Association on state securities regulation and dual federal-state role said:

> It is not clear from the legislative history or the circumstances of enactment whether anyone in Congress or anyone otherwise connected with the bills had any systematic understanding of what the relations of state and federal securities regulations should be, how regulatory responsibilities should be allocated, or how federal disclosure regulation and state merit regulation should be accommodated to each other. In other words, Congress clearly did not intend to preempt state law; it envisioned some kind of coexistence, but the functional relationship of the two regulatory systems was never well defined. The terms of the state-federal alliance forged in 1933 and 1934 therefore were never carefully outlined, and the overall result is a poorly coordinated regulatory structure.[5]

Or as SEC Chairman Levitt recently put it, "many think our combined [federal-state] regulatory structure still looks more like the product of Rube Goldberg than of Thomas Jefferson."[6]

State Regulation of Securities Offerings. Under this system of dual federal and state securities regulation a corporate issuer wishing to make a nationwide securities offering may face the onerous task of ensuring that the offering not only meets federal disclosure requirements and satisfies market demand, but is acceptable under the laws of 52 states and territories. In contrast, in Europe companies can

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[4] L. Brandeis, Other People's Money, ch. 5 (1914).

[5] *Report by the Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, American Bar Association,* 41 Bus. Law. 785, 793-94 (1986).

[6] Remarks of SEC Chairman Arthur Levitt, North American Securities Administrators Association, Vancouver, British Columbia, Oct. 23, 1995. In this address Chairman Levitt announced that he intends to convene a "planning summit" among the SEC, SROs and state examiners to try to promote greater uniformity and predictability in the regulatory scheme. SIA is pleased that Chairman Levitt is undertaking this effort. However, the problems posed by diverse and conflicting state requirements, described below, have resisted many previous efforts by the SEC and others to promote cooperation, and SIA does not believe that these efforts, while worthwhile, are any substitute for legislative action.

raise capital from Rotterdam to Rome while complying with just a single set of regulatory requirements.

As the securities markets have developed, blue sky administrators have become part of a much more complex regulatory structure. The evolution of self-regulatory organizations such as the National Association of Securities Dealers ("NASD") and the New York Stock Exchange has further marginalized many of the functions of state securities regulation. Changes in disclosure systems and market structure have also affected the need for paternalistic regulation on behalf of small investors. In particular, the growth of institutional investors such as pension funds and mutual funds, and their more active role in corporate governance, create a far more level playing field for all investors than may have existed in 1933.

One hallmark of state blue sky regulations has long been regulatory scrutiny of the "fairness" of an offer, independent of the market's judgment. Another feature is that states require certain disclosures in addition to SEC-required disclosure, including disclosure that is unrelated to the economic bona fides of the issuer. The net result is that, over the years, overprotective state regulations have obstructed investment opportunities and encumbered the efforts of companies to raise capital in U.S. markets. New state requirements, including requirements that flatly contradict federal policy, can arise at any time.[7]

The drawbacks of this problematic regulatory scheme have been mitigated by widespread adoption of a uniform law creating a "blue chip" exemption from state merit review requirements for equity offerings by companies listed on the National Market System, such as the major exchanges or Nasdaq. SIA appreciates the efforts of state regulators to create greater uniformity, which took many years of state-by-state legislative work, and only recently accomplished its objective of relative uniformity.

Uniformity for this important segment of the corporate issuer community should not be seen as a panacea. Any state at any time could unilaterally withdraw from the current system, destroying the hard-won uniformity. In fact, one state has already significantly qualified its participation in the blue chip exemption by tacking on a disclosure requirement that relates purely to political considerations that are irrelevant to securities regulation.[8] This suggests that the voluntary uniformity that states have now achieved for blue chip issuers may be a fragile condition that could disappear far more quickly than it was attained.

State Regulation of Investment Companies. Mutual funds and other investment companies face particularly difficult problems with state regulation. Blue sky regulation of the investment company industry imposes burdens on the marketplace that are not justified by the benefits conferred on investors. The SEC has pointed out that this is an area where "[t]he diversity of each state's substantive and procedural blue sky requirements make compliance difficult."[9] Unlike SEC regulation of other types of corporate issuers, the Investment Company Act of 1940 ("Investment Company Act") subjects investment company securities to federal merit regulation, as well as disclosure regulation, making state oversight entirely duplicative.

State regulation makes it difficult, if not impossible, for mutual funds to produce short, readable prospectuses. Many states require mutual fund prospectuses to be

[7] One very recent example is a proposed California ballot initiative that could expose virtually all major U.S. corporations to liability far beyond that permitted under current federal law. The proposal, which among other things would permit private class actions to recover unlimited punitive damages from individual defendants who recklessly assist a fraud, was submitted to the California State Attorney General on October 3, 1995 as a possible state ballot initiative. If enacted, it arguably might apply to lawsuits filed against any company whose securities happened to have been purchased in the secondary market by a pension fund whose beneficiaries include California residents. Such a law would dramatically increase the liability exposure of U.S. securities market participants, inflicting significant harm to the competitiveness of U.S. capital markets and U.S. corporations.

[8] Florida had been in compliance with the uniform system, although it was one of a number of states that required major issuers to make a routine notice filing with the state in order to offer their securities to Florida residents. In 1992, Florida tacked on to this notice requirement an additional requirement that all companies offering securities in Florida disclose whether the issuer or any of its affiliates does business with Cuba or with any person located in Cuba. Fla. Stat. §517.075. We understand from corporate attorneys who have dealt with this provision that it has raised confusion (and of course lawyers' fees) for many companies. For example, companies that happened to have an affiliate that provided office supplies to a Cuban embassy located outside Cuba, that occasionally sent a news camera crew—with State Department permission—to cover stories in Cuba, or that provided a satellite link from the Vatican to the papal nuncio to Cuba have faced difficulties with the Florida law. We understand that a number of these companies have decided to exclude Florida residents from securities offerings, a decision that disadvantages Florida investors and raises the cost of capital for those companies.

[9] *Protecting Investors: A Half Century of Investment Company Regulation*, SEC Division of Investment Management, May 1992, at 217.

reviewed by state examiners, in addition to the merit and disclosure review conducted by SEC staff. Approval of mutual fund prospectuses in these states depends on meeting the approval of a state examiner, often based largely on the particular examiner's subjective personal judgment and preferences. Different examiners in different states may require any number of additions or revisions to prospectus disclosure, resulting in prospectuses which are expensive to prepare but are often of little practical use.

State Regulation of Securities Professionals. State registration or licensing requirements for securities professionals are also often illogical, overreaching or dysfunctional. Many states require securities brokers to register with the state even if the broker only has a very tangential relationship with the state.[10] For example, Florida and Arizona are among the states requiring out-of-state brokers to register if any of their clients take up residence within the state. Arizona will require a broker in Michigan to register if, without the broker's knowledge, a client moves to Arizona for the winter and places an unsolicited order with the broker.

Likewise, many states require a broker to re-register with the state when he or she moves from one firm to another. Thus, a broker who has taken pains to register in every state where his or her clients have a presence may need to repeat that process if moving to a securities firm across the street. This results in duplicative expense and delays for the broker in resuming business.[11]

Failure to comply with state registration requirements such as these can have extremely grave consequences that far exceed anything under federal law. Under the Uniform Securities Act, which is the nucleus of state efforts at uniformity, failure of broker-dealers or their employees to comply with state registration requirements is a felony.[12] In addition, even technical nonregistration infractions can entitle a securities purchaser to rescind the transaction, even if the nonregistration bears no relation to the loss. Each sale is treated as a separate violation, so that a purchaser can affirm money-making transactions and disaffirm only losing trades.[13]

A number of states also have fee structures for broker inspection regimes that are very questionable, particularly since similar examinations of the same broker-dealers are conducted by the SEC, NASD and other ("SROs"). For example, one state imposes an inspection fee on individual brokers registered in that state when they are examined. The fee of $100 per examiner per day plus actual costs of transportation and lodging is in addition to the registration fee, and applies even to inspections occurring outside the state.[14]

The state regulatory regime for broker-dealers could become even more burdensome under a proposed recordkeeping requirement under consideration for adoption as a model by the North American Securities Administrators Association ("NASAA"). NASAA is currently proposing a model set of state record-keeping re-

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[10] Some states require registration for anyone who calls into the state to provide information about a securities firm, even if the caller transfers any potential client to a broker who is registered in the state. *See. e.g.*, South Carolina Securities Division Statement of Policy 95-1; Idaho Securities Bulletin, Policy Statement No. 94-4 (Sept. 1994).

[11] This re-registration requirement is an inefficient way of screening out "bad apples." "As things stand today, a broker can accumulate a number of complaints and trigger no regulatory review as long as he stays with one firm. Because it is legally easier to deny a license than to revoke one, the system focuses your attention on the point in time when a broker changes firms. Although I understand the reasons for this, investors would be better protected if our response were triggered by complaints, not by job changes." Remarks of SEC Chairman Arthur Levitt, North American Securities Administrators Association, Vancouver, British Columbia, Oct. 23, 1995.

[12] Uniform Securities Act §409.

[13] Uniform Securities Act §410; C. Long, *Blue Sky Law*, vol. 12, §1.04[3] at 1-14 and cases cited therein. For example, a national broker-dealer that was registered in Oregon was required to rescind losing transactions that were handled by an agent in San Francisco who was not personally registered in Oregon. *Stimmel* v. *Shearson, Hammill & Co.*, 411 F. Supp. 639 (D.Or. 1976)

[14] N.M. Stat. Ann. §58-13B-15 and Rules of the Director of the Securities Division of New Mexico, as Amended, SD Rule 86-3.07 (1995). Other states have similar fee-per-inspection schemes. *See, e.g.*, N.H. Rev. Stat. Ann. §421-B.9VII (examination fee required to be charged against broker-dealer being examined unless it is a domestic issuer-dealer); Ind. Code §23-2-1-10(f)(examination fees permitted against broker-dealer offices under investigation); Minn. Stat. §80A.28(8)(same). Leaving aside the potential violations of securities brokers' Constitutional rights that such fee structures may invite, this approach is disturbing public policy. Like brokers, motorists are required to register with the state and are subject to inspection when they are driving. One can imagine the public outcry, and the opportunities for abuse, if a state's highway patrol collected $100 from every motorist who was pulled over, even if no infraction was charged.

quirements that it would recommend be adopted by all 50 states.[15] This is a classic example of a solution in search of a problem. Broker-dealers are subject to comprehensive record-keeping requirements by the SEC, the NASD and other SROs.[16] The NASAA proposal would add a new layer of regulation at a time when excessive regulation and other barriers to competition are being eradicated around the world. At the behest of SEC Chairman Levitt NASAA recently decided to defer final action on its proposed requirements until early 1996, while it works with the SEC to address whatever deficiencies it perceives in federal recordkeeping requirements.

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Section 3 of H.R. 2131 appropriately preempts unnecessary and obsolete state regulation of investment companies. It also systematically rationalizes the interrelated roles of federal and state regulation by carefully addressing each of the major areas of state securities regulation and distinguishing between areas where states should play a role and areas where they should not.

There are three aspects to state blue sky regulation: (1) provisions regarding the registration of securities; (2) provisions regarding the registration or licensing of persons engaged in the securities business; and (3) antifraud provisions. HR 2131 prescribes different approaches to dual federal and state regulation in each of these areas. The bill preserves a state role in each area, but delineates that role much more precisely and sensibly than does current law.

1. Registration of Securities. *Issuers Regulated Under Securities Act.* Section 3(a) of the bill would amend Section 18 of the Securities Act to generally exempt securities from state law requirements if they are registered under the Securities Act. State securities laws would also be preempted for securities offered in interstate commerce that fall within certain exemptions under the Securities Act.

The provision is careful to preserve state jurisdiction in a number of areas.

- State law could still be applied to securities that are exempt from registration under the intrastate offering exemption contained in Section 3(a)(11) of the Securities Act.
- If a security offered or sold using an instrument of interstate commerce is exempt from registration under some provision other than Section 3(a) of the 1933 Act, the SEC may by rule exclude the security from federal preemption if it finds that the public interest and protection of investors would be served by state regulation.
- Offerings by blank check companies would be subject to state securities laws.
- Proposed new Section 18(b) of the 1933 Act would permit state securities commissions to require state filing of certain notice filings made with the SEC.
- State securities agencies would continue to have concurrent jurisdiction over conduct that violates Section 17(a), the anti-fraud provision of the 1933 Act.

Issuers Regulated Under the Investment Company Act. Section 3(c) of the bill would amend Section 50 of the Investment Company Act to provide the SEC with exclusive jurisdiction over investment companies.

SIA's View. SIA believes that HR 2131's approach to state securities regulation of securities offerings is a vast improvement over current law. We have laid out above many of the problems with state regulation of national securities offerings. HR 2131 strikes an appropriate balance by eliminating the burdens while preserving state blue sky law in certain areas not regulated by the SEC, such as intrastate offerings. Giving the SEC authority to reopen specific categories of securities offerings to state regulation, while probably unnecessary, is an ingenious safeguard to ensure that there is no undesirable gap between state and federal regulation. State regulation of investment companies has been particularly troubling, and the bill's approach of flatly preempting state regulation in this limited area is both restrained and highly appropriate.

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[15] Proposed Rule 203(a)-2, NASAA Broker-Dealer Regulation Committee. The NASAA proposal would create recordkeeping obligations far beyond what is required by federal regulation Whole new categories of records would be required to be maintained for a six year period, even if the broker goes out of business. Moreover, the proposed model statute would permit state examiners to have access to any records whatsoever in the broker's possession or control "that may lead to evidence pertaining to its business" without a subpoena or any other demonstration that the state examiners have a valid reason for wanting to see the document.

[16] These requirements can be enforced not only by these nationwide authorities, but also by state agencies. Provisions of the Uniform Securities Act in effect in most states give state agencies broad authority to examine records, seek injunctive relief, suspend or revoke registrations, or even seek criminal sanctions for violations of state record-keeping requirements. States usually seek to make their recordkeeping requirements consistent with federal requirements. *See, e.g.*, Del. Code Ann. Title 6, §7315.

2. Regulation of Securities Professionals. Section 3(b) of the bill would amend Section 15 of the Securities Exchange Act of 1934 ("Exchange Act") to add a new paragraph (h) preempting state laws requiring state registration or licensing of brokers or dealers in the case of (i) any entity registered under the 1934 Act as a broker, dealer, municipal securities dealer or government securities broker, or exempted by the SEC from registration; (ii) any issuer; (iii) any member of a national securities exchange; (iv) any person associated with any of the above. In addition, states would be barred from imposing capital requirements, financial reporting obligations or books and records requirements that differ from SEC requirements.

Federal preemption of state law governing brokers and dealers would be limited in three important respects:

- First, a state could require a person other than an issuer to register or be licensed if the state's registration or licensing procedures are conducted through the NASD's central registration depository system, and the state's requirements are "substantially similar to" the SEC's or NASD's registration requirements; Moreover, a state's ability to administer and enforce its registration requirements and other state securities laws would be expressly preserved.
- Second, the preemption would not apply to state laws imposing "requisite fees in connection with the registration, licensing, or qualification of persons within the coverage of this subsection."
- Third, the SEC could shelter state requirements from federal preemption "upon a finding that the public interest, the protection of investors, and the maintenance of fair and orderly markets would be served by such State regulation."

Section 3(d) would change Section 222 of the Investment Advisers Act of 1940 ("Advisers Act") to preempt entirely state regulation of investment advisers that are regulated at the federal level.

SIA's View. The bill's approach to dual federal-state regulation over securities brokers is a clear improvement over current law. A savings clause permits the SEC to expand the state role if necessary. This provides insurance that no unforeseen gaps might arise between federal and state regulation. Each state would continue to perform its proper function of policing brokers registered with that state. The bill expressly preserves the ability of states to continue using their enforcement authority to identify and prevent fraud and other wrongdoing by brokers before investors are harmed.[17]

The bill's approach to dual state and federal regulation of securities professionals might be improved in some respects. For example, HR 2131 preserves the ability of states to impose registration fees as long as their substantive registration requirements are consistent with federal requirements. As an alternative, it might be desirable to consider other approaches to the current hodgepodge of state fees that might be more efficient and result in lower fee rates charged in a more equitable fashion, without necessarily reducing net revenue to states.

One such approach would be to create an optional system of national registration. Under such a system, a securities broker could choose either to register with each state in which he or she transacts business, or could enter a national registration system, operated by the SEC, the NASD, the states, or some combination of them The national registration system would have a uniform fee structure for all brokers who enter that system, and fees collected would be prorated among the 50 states, with a small portion taken out for the system's operational expenses. Brokers entering the national system would be exempt by federal law from registering with individual states. This approach would greatly reduce the tendency of state registration requirements to trap unwary out-of-state brokers, and could make it less costly for states to collect fees.

The bill would not impede states' ability to conduct inspections. However, states should not be permitted to adopt and apply inspection schemes that are far broader than federal inspection requirements. The bill requires that state books and records requirements and financial reporting requirements must be consistent with SEC requirements. This provision would be significantly undercut if state inspection requirements and practices differ from each other and from SEC requirements. There is currently no structure in place for effective coordination among state examiners, the SEC and other regulators. Moreover, under the guise of state law inspection authority, state examiners are sometimes invested with highly questionable powers, such as those discussed above. SIA suggests that the bill should clarify that state inspection requirements must be consistent with SEC requirements. In addition, as discussed below, the SEC should be charged with coordinating examinations among states, and between the states and other regulators.

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[17] HR 2131, Section 3 (b)(1)(adding new subsection 15(h)(6) to Securities Exchange Act).

Federal preemption of state law in the area of investment advisers raises special issues. While state regulation in this area is not beyond reproach, there has been widespread agreement that a lack of resources has caused the SEC's regulatory oversight in this area to fall behind other areas. Federal preemption in this area is a worthy proposal. An alternative approach is proposed in a pending Senate bill.[18] SIA hopes to work with the sponsors of both bills to find an appropriate delineation of functions between state and federal regulators regarding investment advisers.

3. Antifraud Enforcement. HR 2131 leaves in place state antifraud authority. Section 3(a)(1) of the bill amends Section 18 of the Securities Act, *inter alia*, by adding new subparagraph (c)(2), which expressly preserves state authority over conduct that violates Section 17(a), the primary antifraud provision of the Securities Act.

SIA's View. SIA has always supported a "tough cop on the beat" and we strongly support preservation of state antifraud authority. While many or most aspects of state blue sky regulation are duplicative, burdensome or counterproductive, states have a legitimate role to play in policing the securities markets against fraud.

The bill could be modified to ensure that the objective of policing against fraud is not misused for other purposes that can detract from real deterrence of fraud by clogging courts with dubious cases. For example, the bill does not limit the ability of state law to undermine federal policy on securities lawsuits. As previously noted, plaintiffs' lawyers may be seeking to exploit this loophole so that a single state's broader liability standards might be applied to a company located anywhere in the United States if its stock is purchased by that state's residents in a primary or secondary market purchase. The objective of this legal tactic would be to nullify federal liability standards under Section 10(b) of the Exchange Act, which have evolved over decades of federal court decisions. SIA would be happy to suggest language to prevent this type of end-run around federal policy.

Similarly, the bill could be modified to prohibit states from using broad laws or regulations to create civil liability for securities or transactions otherwise exempt from state law and not in violation of federal anti-fraud provisions. As currently drafted, the bill may permit states to apply broad-gauged laws to securities transactions that are not fraudulent under any reasonable definition of the word. Again, the purpose of state enforcement actions should be to deter and punish fraud. Creating draconian state liability for technical rule violations and other non-fraudulent conduct for which appropriate federal and SRO administrative sanctions already exist detracts from that purpose.

B. Suitability and Institutional Investors.

The securities industry has long recognized that, in the case of an individual or "retail" customer, a broker who recommends an investment must have a reasonable basis to believe that the investment is appropriate to that customer's financial circumstances and investment objectives. This precept is rooted in the notion that in selecting securities, retail customers rely on the knowledge and expertise of their broker. In the retail sales context in which the suitability doctrine was developed, it is a sound component of the obligation of brokers to treat their customers fairly. Most retail customers rely on a single broker as a source of investment advice and are willing to disclose to the broker financial and personal data, investment objectives, portfolio composition, and similar kinds of information necessary to permit the broker to determine what investments are suitable for the customer. Conversely, a retail customer that is the object of an unsolicited contact by a broker is entitled to expect that the broker will gather the necessary information to make a suitability determination before making a recommendation. The members of SIA take their suitability obligation regarding recommendations to retail customers seriously, and nothing in H.R. 2131 would affect those obligations.

However, in the case of an institutional client, the presumption in our industry is the opposite—that the client is making its own decisions and relying on its own myriad sources of advice and does not therefore expect a broker to interject its views concerning the suitability of the institutional client's trades. Moreover, the principles upon which the retail customer suitability obligation is founded customarily do not apply in the institutional market. Unlike the typical retail customer—

- Institutions are frequently sophisticated and active participants in determining their own investment strategies. Institutions often employ investment professionals or retain external advisers to aid them in selecting investments. In many cases, the broker's role is merely to effectuate a strategy devised by other professionals.

[18] Investment Advisers Integrity Act (S. 148).

- Many institutions are unwilling to disclose their overall investment methodologies and portfolio holdings to a broker. Investment plans are typically treated as proprietary and confidential.
- Many institutional clients use the services of several brokers. Even if some portion of the institution's strategy and objectives are revealed incident to obtaining brokerage services, any one broker is unlikely to be privy to the institution's total portfolio. No brokerage firm can therefore effectively assess the suitability of a particular investment.

For these reasons, the concept of suitability loses its meaning in the case of the typical institutional customer. The institution will have formulated an investment strategy, one component of which is risk tolerance. For a broker to attempt to make its own determination concerning whether any particular trade is "suitable," would require the broker to undertake a re-evaluation of the institution's entire strategy. Few institutions want or need this type of second-guessing from brokers.

Of course, on occasion, some institutional investors require investment advice from their brokers and are willing to provide the information necessary to enable the broker to assess whether particular investments are appropriate to the institution. Institutional clients of this nature are, however, the exception, not the rule. Therefore, where an institution is relying on its broker in this fashion, it is not unreasonable to require that the institution clarify that understanding with the broker in writing in advance of trading. In the institutional market, advance agreements of this nature would protect the institutional client from misunderstandings concerning the scope of the service provided by the broker. In addition, such agreements protect both the institution and the broker from hind-sight disputes concerning the discharge of a suitability obligation which the broker, in good faith, did not believe existed.

It might be argued that, since the suitability doctrine benefits the retail customer, there is no harm in extending its protection to institutions and that, in particular cases, brokerage firms and institutional clients can contract out of this duty if they wish to do so. In fact, application of the suitability doctrine to institutional trading leads to a variety of problems and unintended consequences.

First, the ability to fall back on a suitability claim may actually discourage institutions from installing the types of sophisticated decision-making and internal controls that should be the hallmark of entities responsible for deploying large aggregations of investment capital. A fundamental premise of our capital markets is that risk and reward go hand in hand. If institutions believe that the securities laws will permit them to transfer losses to their brokers, the incentive to bring sophistication and prudence to bear on the investing process is eroded. This is hardly in the interest of institutional clients or the integrity of the market generally.

Second, in virtually every case, at the time of the transaction, the broker believes that its institutional client is not relying on the broker with respect to suitability. In general, institutional unsuitability claims against brokers reflect an after-the-fact assertion by the client's governing body that the client was relying on the broker.[19] Those institutions that wish, contrary to typical practice, to secure a suitability determination from their broker should make that fact clear in advance.

Third, in the institutional context, it is often highly ambiguous whether a particular transaction was "recommended" by the broker. In many cases, the institution's employees will routinely discuss market conditions, forecasts concerning interest rates, the merits of specific securities, and similar matters with the brokerage firm's representative. The parties may, in hind-sight, disagree concerning whether these discussions constituted a "recommendation" by the broker on which the client relied.

Fourth, absent legislation, the ability of even willing institutional clients to contract out of the suitability obligation is uncertain. Attempts to do so may themselves spawn litigation. As a general proposition, the securities laws do not permit contractual waivers of rights arising under those laws.[20] Further, the SROs generally will not permit a member to abrogate by contract obligations imposed under SRO rules. Thus, absent Congressional action, binding agreements concerning the suitability obligations owed to a particular institutional client may not be possible.

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[19] This is not necessarily an indicium of bad faith on the part of the client. In some cases, the individual dealing with the broker on behalf of the institution may have been exceeding his or her authority or misrepresenting his or her competence and sophistication. When losses result, the institution's governing body may well conclude that the institution, as an entity, was unsophisticated and was relying on its broker, notwithstanding the impressions given by the employee. These situations are fertile ground for litigation between an institution that has lost money and the broker that has, from its perspective, merely followed the instructions of a putatively sophisticated client.

[20] *See, e.g.*, Securities Exchange Act Section 29.

Finally, the risk of hind-sight allegations that the suitability obligation was breached will diminish the willingness of reputable securities firms to deal with all but the most obviously sophisticated institutions.

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For these reasons, market practice concerning the relationship between brokers and institutional clients should govern, and exceptions should be dealt with by contract. In the unusual case where the institution wishes to have the benefit of the broker's advice (in the form of the application of the suitability doctrine), the parties should expressly so agree, and the client must be prepared to provide the broker with the information necessary to permit it to reach an informed conclusion. Conversely, in the more common case of institutional clients that, either through the employment of professionals or the retention of other outside advisers, have other sources of investment advice, the institution should not expect its brokers to assume liability if the client's investment strategy proves unprofitable.

Section 2 of H.R. 2131 is consistent with these objectives, and we support its enactment. H.R. 2131 correctly recognizes that the relationship between an institutional client and its broker is distinct from that of a retail client and his or her broker. Institutional clients rarely rely on their brokers for investment recommendations, drawing instead on internal resources or professional advisors for investment guidance and strategy. Section 2 would embody this concept and also make clear that the scope of the broker's responsibilities should be a matter left to negotiation and agreement between the parties.

H.R. 2131 would address the issue of the application of the suitability doctrine to institutional customers in three ways—

First, it would preclude SROs from adopting rules that make a member "responsible for the investment decisions of an institutional client."[21] Thus, for example, SROs would have to clarify that their existing rules, such as Section 2 of Article III of the NASD's Rules of Fair Practice, and Rule 405 of the New York Stock Exchange, do not impose blanket responsibility for determining suitability in the case of institutions.

Second, this prohibition would be qualified by permitting SROs to adopt rules relating to suitability obligations toward institutional clients where the broker-dealer and the client "have expressly agreed in writing prior or contemporaneously with the recommendation" that the recommendation will be made "on a reasonable belief that the recommendation is suitable for such institutional client based on facts disclosed by such institutional clients as to its other securities holdings and as to its financial situation and needs." Thus, brokers and institutional clients could, by contract, create a suitability obligation.

Third, Section 2 would create a presumption that, in any action brought against a broker or dealer under the Exchange Act or the rules thereunder, the broker or dealer is not liable for the investment decisions of an institutional client. This presumption could only be rebutted upon proof of a written agreement of the kind described above.[22]

A provision of this nature would relieve brokers of the risk that they will be charged, after the fact, with breaching their suitability obligations in circumstances where the broker was led to believe that no such obligation existed. At the same time, it would permit brokers to discharge suitability obligations to those institutions that desire this type of service and are prepared to provide appropriate information necessary for a suitability determination. It would also have the effect of making clear to institutional customers, especially to the governing bodies of less sophisticated institutions, the exact nature of the relationship between securities firms and the institution's agents.

It is also important to recognize what H.R. 2131 would not do. It would have no impact on the suitability obligations owed under existing law to retail customers or to institutional investors that do not meet the $10 million threshold. Further, it would not authorize fraud or permit a breach of fiduciary duty, violations for which there are appropriate remedies under applicable laws. The purpose of Section 2 of H.R. 2131 is merely to recognize that, in the special area of suitability, institutional

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[21] An "institutional client" would be defined as "any person other than a natural person that has at least $10 million invested in securities in the aggregate in its portfolio."

[22] The legislation would also make clear that it does not itself create any private right of action. The courts have generally held that there is no implied private right of action under the rules of the securities industry self-regulatory organizations. *See, e.g., Jablon* v. *Dean Witter & Co.*, 617 F.2d 677 (9th Cir. 1980); *Pierson* v. *Dean, Witter, Reynolds, Inc.*, 551 F. Supp. 497, 501 (C.D. Ill. 1982). The bill would leave this long-standing proposition unchanged.

and retail customers are quite different and that the legal framework governing the relationship between broker and client should reflect those differences.

C. Margin Requirements.

The changes in the financial markets since the 1930s require a comprehensive review and revision of the various regulations governing extensions of credit by securities firms. Such a revision is necessary in order to ensure the continuing ability of broker-dealers to compete effectively in the global financial markets. We believe that the continued disparities between the margin requirements imposed upon U.S. securities firms and those applicable to other financial institutions are indefensible in light of the fact that there are no longer significant constraints on the ability of banks and other entities to compete directly with brokers.

We have identified three primary reasons that mandate a substantial overhaul of the margin rules: the increasing internationalization of the capital markets; the greater role assumed by institutional investors; and the increasing pace of financial innovation. Below is a brief discussion of these topics.

Internationalization of the Capital Markets. As discussed in Section I, over the past decade the capital markets have become increasingly global, resulting in a markedly more efficient capital raising process, and greatly increasing the level of competition between and among financial institutions seeking to serve customers on a world-wide basis. An ever-growing class of large corporate clients are indifferent as to where they raise capital or obtain financial services. Foreign financial firms, generally free from the constraints of the regulatory regime imposed on domestic firms, often enjoy significant cost and flexibility advantages, placing U.S. broker-dealers at a major competitive disadvantage.

Greater Role of Institutional Investors. Today, institutional investors play a much greater role in the capital markets than was the case in the 1930s when the legislation currently governing credit extensions by broker-dealers was established. In the fifty years since World War II ended, institutional ownership of U.S. equity securities grew from 6% to 50%. Institutional investors now own 92% of U.S. corporate debt securities, compared to 64% in 1945. The regulatory framework for margin created in 1934 was not designed to reflect this institutional presence, and now substantially hamstrings the ability of broker-dealers to service such clients.

Increasingly, institutional investors seek the assistance of a financial firm that can precisely tailor a transaction to meet their unique objectives and risk profiles. Too often, however, the current margin regulations—such as the restrictions on cross-margining, netting, and the pledging of collateral—preclude broker-dealers from providing such individualized services. As a result, institutional customers increasingly take their securities business to foreign firms and foreign markets where appropriate financing is available. A regulatory structure that would permit securities firms to make appropriate distinctions between retail and institutional customers would go far to address this problem.

Financial Innovation. As discussed above, there has been a remarkable innovation in financial products. These products have permitted investors and corporate end-users to engage in risk management to a degree previously unavailable to capital markets participants. In many cases, these products and the implementation of financial strategies that they make possible create bilateral credit exposures. However, the current margin regulations applicable to broker-dealers largely fail to accommodate such arrangements.

For example, Regulation T requires a broker-dealer to receive margin in circumstances where—absent the regulation—the economics of the transaction would require the broker to provide margin to the customer. Institutional customers, increasingly sophisticated about managing credit risk, often refuse to do business with broker-dealers in these circumstances. The failure of the current margin regulations to distinguish between an "extension of credit" (the traditional focus of margin regulations) and "credit exposure" has handicapped U.S. securities firms in the competition to provide cutting edge financial services to institutions.

The current margin rules also prevent broker-dealers from efficiently dealing with counterparty risk, resulting in liquidity being drained from the market. Securities firms are not permitted to cross-margin commodities exposures and securities exposures. Rather than permit the cross-margining of positions that move inversely—such as a long securities position hedged by a short futures position—the margin rules require that market participants collateralize such exposures separately. Consequently, capital is tied up collateralizing positions that otherwise could collateralize each other. Such an inefficient use of capital effectively removes it from the market and diminishes market liquidity. This also adversely affects the ability of U.S. broker-dealers to compete with domestic and foreign financial institutions that do not labor under such constraints. Thus, ironically, regulations intended to

reduce risk have the net effect of discouraging corporate end-users and broker-dealers from engaging in risk-shifting and hedging activities.

* * *

Section 4 of HR 2131 is an important step toward eliminating obsolete and inefficient restrictions on margin. Section 4(a) would eliminate federal margin requirements for most major financial institutions unless the Board of Governors of the Federal Reserve System finds that such action is necessary to address "substantial instability or the imminent threat of substantial instability in the financial markets." This section would also bar self-regulatory organizations from adopting margin requirements that are more restrictive than requirements set by the Federal Reserve Board. Section 4(b) of HR 2131 would strike Section 8(a) of the Exchange Act, which prohibits broker-dealers from borrowing against registered equity securities except if the lender is another broker-dealer, Federal Reserve member bank, or a non-member bank that has met certain conditions. HR 2131 would eliminate this provision, thereby permitting broker-dealers to obtain financing from a wider range of entities. This would permit broker-dealers to obtain capital at the lowest possible cost, strengthening their competitiveness vis a vis other financial institutions. Section 4(c) would permit broker-dealers to extend credit to most types of institutional customers in securities for which the broker-dealer acted as part of a distribution syndicate within 30 days prior to the transaction, unless the SEC by rule restricts such an extension of credit. This would make it easier for broker-dealers to make markets in securities that they underwrite.

It should be noted that some of our members have worked with the SEC and the Federal Reserve on an alternative approach to modernizing federal margin restrictions. This alternative approach generally would remove restrictions on the sources of financing for broker-dealers, shift the authority to set margin restrictions for most debt securities to SROs, remove margin restrictions on lending to broker-dealers that do a substantial public business or for market making or underwriting activity, and grant the Federal Reserve Board and the SEC broad exemptive authority to create further exemptions from margin requirements.

SIA believes that both HR 2131 and the approach supported by the SEC and Federal Reserve Board would generally be an improvement over current law. The two approaches are similar in many respects, although the SEC-Federal Reserve approach is less far-reaching. Notably, it does not create complete parity of treatment between banks and securities firms that is accomplished by H.R. 2131, and continues to regulate financing of many fixed income transactions. SIA believes that both Congress and the SEC, Federal Reserve and other regulators should continue to examine margin issues to ensure that U.S. requirements (and exceptions to those requirements) accommodate modern financial instruments traded in a global environment and do not impose artificial or inappropriate restrictions on trading and investment. SIA also believes that changes in margin rules should neither create market instability nor discriminate inappropriately between different classes of investors.

D. Broadened SEC Exemptive Authority.

In a regulatory environment as complex as the one governing the securities industry, regulatory underbrush inevitably builds up over time. Where it is within its power to do so, the SEC has generally done a good job of keeping regulatory growth from choking the capital markets, and has often shown flexibility and ingenuity in adapting its regulations to fit changing market conditions. For example, the Investment Company Act allows the SEC to exempt any person, security or transaction from regulation if the SEC finds that the exemption is consistent with the purposes and policies of the securities laws. This permits the SEC to shape the letter of the law to fit the spirit of the law. The Advisers Act and certain provisions of the Exchange Act contain similar exemptive authority.

The SEC has generally used these provisions in a constructive way, keeping the regulatory framework flexible without compromising the purposes of the statutes it administers. Notably, Section 7 of HR 2131 would provide the SEC with similar exemptive authority under the Securities Act. SIA believes that the SEC's exercise of any exemptive authority should be linked to the proposal in Section 8 of the bill that requires SEC regulatory actions to consider "whether the action will promote efficiency, competition and capital formation." With this caveat, SIA strongly supports this provision, which should further enhance the SEC's ability to keep securi-

ties regulation up to date with the markets.[23] Moreover, SIA believes that similar broad exemptive authority should be extended to the Exchange Act, where the SEC's existing exemptive authority is too narrow in some respects.

E. Designation of Primary SRO and Examining Authority.

There has long been Congressional and SEC interest in better cooperation among SROs' inspection efforts. For example, when Congress enacted the 1975 amendments to the Exchange Act, the Commission was given the authority, in order to "foster cooperation and coordination among self-regulatory organizations," to relieve SROs of examination authority and other specified regulatory functions, and to "allocate among self-regulatory organizations the authority to adopt rules with respect to matters as to which, in the absence of such allocation, such self-regulatory organizations share authority under this title."[24] Based on this authority, the SEC adopted Rule 17d-1, which establishes a system for SEC designation of a single examining authority for broker-dealers that is limited to auditing for compliance with capital requirements.

Section 12 of HR 2131 is an incremental step in these legislative and regulatory attempts to reduce unnecessary duplication of effort among regulatory examinations. The bill would amend Section 15 of the Exchange Act to require the SEC to designate for each broker or dealer one self-regulatory authority as its examining authority. That designated examining authority would enforce both its own rules and the rules of other SROs of which the broker or dealer is a member. A broker or dealer would be able to ask the SEC to change its designated examining authority. Such a change would not alter any pending disciplinary proceeding that the originally designated examining authority brought against the broker or dealer.

SIA strongly supports this "good government" effort to improve coordination among examining authorities. There are some respects in which the provision could be strengthened. For example, the provision does not address duplicative examinations by state examiners.[25] The efficiency and effectiveness of all examination programs would be improved, and the regulatory burden on broker-dealers lessened, if the SEC were given the authority and direction to coordinate the roles of multiple state examiners as well as SRO examiners, and to coordinate its own examination program with the programs of SROs, states, and other federal examiners.[26] As Chairman Levitt recently told state regulators, "with a limited number of cops, it is important that we don't all walk the same beat."

SIA also recommends adding language to clarify that if a designated examining authority finds evidence of a violation of the rules of a different SRO, the designated examining authority or the broker or dealer could have the matter transferred to the SRO whose rules are at issue. While Section 12 would indirectly encourage greater harmony among SRO rules, it would still be desirable to have a mechanism like this to avoid the possibility that an examining SRO might misapply the rules of another SRO.

CONCLUSION

The federal securities laws have generally served the country well during the sixty two years since the Securities Act of 1933 was enacted. However, as with any law of such long vintage, changing times and circumstances have made some provisions obsolete, threatening to impair the future economic growth and the competitiveness of the U.S. financial services industry. These concerns require a legislative

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[23] This provision may also be a useful means of resolving an issue raised by another provision of the bill. Section 6 of the bill proposes to abolish the current statutory requirement that a prospectus be delivered concurrently with every sale of a newly issue security. SIA believes that the current prospectus delivery requirement is too inflexible, and in many circumstances imposes costs without ensuring delivery of useful and timely information to investors. Providing the SEC with authority to create exemptions to this requirement might be a simple and effective way of addressing this concern.

[24] Exchange Act § 17(d)(1).

[25] It should be noted that the SEC recently held a "planning summit" among SROs and representatives of state regulators. The summit resulted in a "Memorandum of Understanding" in which the signatories pledged to better coordinate SRO examinations, and to encourage state authorities to use their inspection authority more efficiently. SIA is pleased with this development, but notes that the SEC lacks the ability to require state examination authorities to coordinate with each other or with other regulators. The current interest of some state agencies in voluntary cooperation, which has been on display since introduction of HR 2131, is encouraging but is no substitute for legislation.

[26] The SEC already is required by law to coordinate with bank regulators on the inspection of bank-owned municipal securities dealers, transfer agents and clearing agencies. Exchange Act § 17(b).

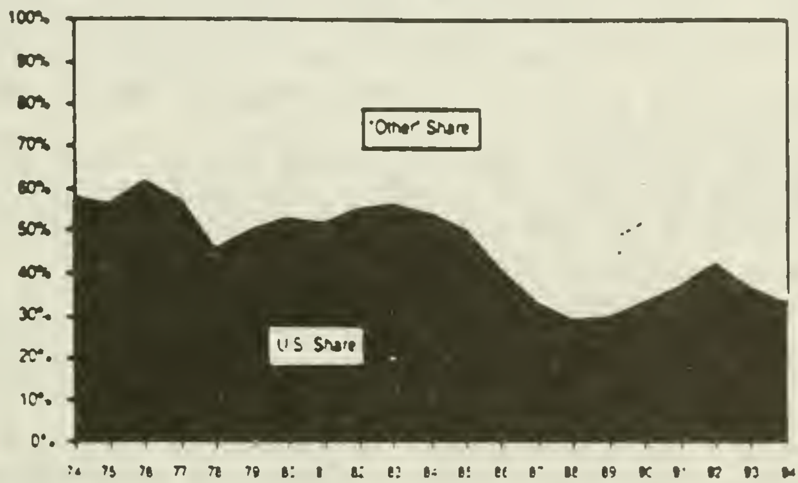
response that preserves the successful aspects of the federal securities laws, while identifying and improving those provisions that have become hindrances to the markets, and ultimately to investors. HR 2131 is just such a legislative response.

Careful legislative efforts to address these issues, such as embodied in this legislation, are necessary to ensure that our securities markets continue to be the world leaders and a key source of American economic vitality in the 21st century. HR 2131 is a promising beginning to the process of Congressional examination of the regulation of our Nation's capital markets. It is our hope that the result of this process will be enactment of legislation that enhances the pre-eminence of our capital markets by reducing unnecessary regulatory burdens, increasing the efficiencies of our capital markets, and maintaining the high standard of investor protection that is so essential to the functioning of our system.

Thank you very much.

EXHIBIT A

U.S. Share of World Equity Market Capitalization



	% of U S Share	% of "Other" Share
74	58	42
75	56	44
76	62	38
77	57	43
78	46	54
79	50	50
80	53	47
81	52	48
82	55	45
83	56	44
84	54	46
85	50	50
86	41	59
87	33	67
88	29	71
89	30	70
90	33	67
91	37	63
92	42	58
93	37	63
94	33	67

Source: Securities Industry Association

Mr. FIELDS. Thank you, Mr. Krongard.

Ms. Elaine LaRoche, Vice-Chair, Public Securities Association.

STATEMENT OF ELAINE LaROCHE

Ms. LAROCHE. Thank you, Chairman Fields, and good morning.

I am Elaine LaRoche and I am Managing Director of Morgan Stanley & Co., Inc., in New York. And also, as you have indicated, Vice-Chair of the Public Securities Association. It is in that capacity that I appear before you today.

PSA is the bond market trade association representing securities firms and banks that underwrite trade and sell debt securities both domestically and internationally.

I would first like to commend you, Chairman Fields, for your leadership in drafting and introducing H.R. 2131. After 60 years a comprehensive review of our Nation's system of market regulation is, without a doubt, called for. We strongly support many provisions in your bill, Chairman Fields, and we appreciate your efforts and those of other members of this subcommittee in leading this important public debate.

To keep my statement short, I would like to focus my remarks on the issue of institutional investor responsibility and on Section 2 of H.R. 2131, since the bill would not change dealer suitability obligations to individual investors.

My written statement discusses other provisions of the bill in greater detail than time allows here. As Chairman Levitt has said himself and acknowledged before this committee, suitability is a very complex issue.

The role of a securities dealer is sometimes confused with that of an investment advisor. This is unfortunate, because the two are very distinct. Securities dealers assume risk and provide market access in the over-the-counter markets, including most bond markets. They act as principals by directly buying from or selling to customers.

Investment advisors, on the other hand, earn fees by providing advice on investment decisions. They act as fiduciaries with respect to their clients. In fact, investment advisors generally are not permitted to act as principals with their clients. This distinction is important in determining what should be the respective responsibilities of securities dealers and institutional investors.

At the outset, I want to be very clear. I am not here today to defend fraudulent practices by securities dealers, whether in the institutional markets or in any other market. With that said, PSA's views on suitability are simple: Institutional investors must take responsibility for their investment decisions. They should not be able to shift responsibility for their investment decisions to securities dealers with whom they do business.

Managing an organization's investment portfolio takes knowledge, skill, experience and analytical tools that very few who aren't investment professionals possess. Managing someone else's money also represents a tremendous trust and responsibility. If an investment manager doesn't have the capability to fulfill that responsibility, they should hire someone who does.

It's been said that an unsuitable investment is one that loses money. Considering the growing group of institutional investors

that have sought to assign blame for important investment performance on dealers from whom they bought securities, that statement appears true. This apparent trend, if it continues, will cost billions in market efficiency. The result will be less capital formation and a weaker economy.

The suitability provisions of H.R. 2131 recognize the basic tenet that dealers should not guarantee investment performance for institutional investors. The bill would establish a presumption against dealer liability in cases where a dealer recommends a security to an institutional investor with a portfolio larger than $10 million; the presumption would be rebuttable by a written agreement between a dealer and its institutional customer.

The suitability provisions of H.R. 2131 have been grossly mischaracterized. The bill is not intended to permit dealers to engage in fraud. We believe that under the bill, dealers who commit fraud should be fully subject to prosecution and it is wholly appropriate.

The bill would also not change dealer suitability obligations to individual investors or institutions with less than $10 million.

Finally, the bill would not, quote, "allow dealers to sell unsuitable investments" to their customers as some have suggested. That kind of characterization misses the point entirely.

A dealer should not be presumed to be in a position to judge the appropriateness of an institutional investor's decisions. Dealers rarely have access to complete information on the customer's portfolio or strategy, and dealers are rarely in a position to determine whether an investment is truly appropriate.

Only the institutional investor himself or herself or their paid investment advisor can make that determination. H.R. 2131 recognizes that basic fact.

Current rules related to investor and dealer responsibility have resulted in considerable confusion and uncertainty. We appreciate recent efforts by the NASD to establish workable suitability requirements.

However, the NASD's recent proposed interpretive release would, unfortunately, not result in substantial clarification. Under the proposal, suitability obligations would still depend on an after-the-fact, case-by-case facts and circumstances. Only action by Congress would provide clear guidance. We fully support the suitability proposal in your bill.

PSA also agrees with other proposals in H.R. 2131. PSA supports provisions in the bill related to margin, prospectus delivery and the creation of a national securities' market. In sum, financial markets operate most efficiently when all participants bear their own economic risks, including securities dealers, as well as large institutional investors.

Chairmen Levitt and Greenspan have consistently recognized this point. Managing $10 million is not a responsibility to be taken lightly. The suitability provision in H.R. 2131 would establish once and for all that people who manage other people's money must take their responsibility for their decisions.

Thank you for the opportunity to present our views.

[The prepared statement of Elaine LaRoche follows:]

PREPARED STATEMENT OF ELAINE LAROCHE, VICE-CHAIR, PUBLIC SECURITIES ASSOCIATION

Thank you, Chairman Fields, and good morning. I am Elaine LaRoche, and I am a Managing Director of Morgan Stanley & Co., Inc. I am also Vice-Chair of the Public Securities Association (PSA), and it is in that capacity that I appear here today. PSA is the bond market trade association, representing securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally.

I appreciate the opportunity to present PSA's views on questions related to the Capital Markets Deregulation and Liberalization Act of 1995 (H.R. 2131). PSA believes the bill represents an intelligent and responsible approach to reforming the regulatory structure of the securities markets. Although PSA has not taken formal policy positions on all provisions of H.R. 2131, we strongly support the bill's general approach to market regulation and specifically support numerous provisions in the bill. H.R. 2131 represents an important step in the evolution of safer and more efficient capital markets. By drafting and introducing H.R. 2131, Chairman Fields has initiated the first wholesale review of the regulatory structure of the securities markets since the 1930s. The bill has initiated a debate over the nature of our system of market regulation on a fundamental level. Indeed, as SEC Chairman Levitt said last week, "the bill has prompted the Commission to take a new, hard look at the laws and assumptions under which we operate."[1] We are encouraged that the SEC has undertaken efforts aimed at a thorough reexamination of securities laws and regulations and how they could be streamlined without threatening the soundness of our markets.

We applaud the efforts of Chairman Fields and other members of this subcommittee who have co-sponsored H.R. 2131 and raised the important issues addressed in the bill. We appreciate the opportunity to present our views.

RESPECTIVE RESPONSIBILITIES OF SECURITIES DEALERS AND INSTITUTIONAL INVESTORS

PSA strongly supports the provision in section two of H.R. 2131 related to dealer investment recommendations to institutional clients. This is an issue that has been the subject of increasing attention among regulators, securities dealers and investors in the fixed-income markets in recent years. The evolution of relatively new and complex financial products has brought to the forefront difficult and important questions regarding the responsibility for financial decisions made by institutional investors.

At the outset, I want to be very clear: PSA does not want, and we are not here today, to defend fraudulent practices by securities dealers—whether in the institutional markets or in any other market. We believe firmly in the full enforcement of the anti-fraud provisions of the securities statutes as they apply to both individual and institutional investors. Furthermore, we have supported recent efforts by the SEC to clarify for all market participants the full breadth of coverage of the anti-fraud provisions of the securities statutes.

My remarks this morning on suitability will focus exclusively on institutional investor responsibility and on questions related to investment suitability with regard to institutional, as opposed to individual, investors. PSA believes that distinguishing between institutional and individual investors is, in general, appropriate. The standards for investor responsibility and investment suitability in the institutional markets should, in general, be different from those applicable to individual investors most of whom are not finance professionals and do not make investment decisions for a living. PSA believes that the existing suitability obligations of securities dealers to retail investors are, in general, appropriate.

A bank or securities firm that acts as a securities dealer carries out well defined market functions. It serves as a financial intermediary between and among users of capital and investors. It provides liquidity. It provides market access. It makes markets. It facilitates the purchase and sale of securities among investors by acting as a principal for its own account in transactions and by assuming the counterparty role of buyer or seller. A bank or securities firm acting as a securities dealer puts its own capital at risk and it seeks, in exchange, to be compensated for such risk-taking.

The role of a securities dealer should not be confused with that of an investment advisor. As the name suggests, an investment advisor—for a fee—advises clients on

[1] Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission before the Subcommittee on Telecommunications and Finance, Committee on Commerce, U.S. House of Representatives, November 30, 1995, page two.

investment goals and strategies and makes buy and sell recommendations to its clients, and, unlike a securities dealer which never has such authority, an investment advisor often assumes responsibility for making buy and sell decisions on behalf of its clients. In exchange for its fee, an investment advisor—unlike a securities dealer—assumes a fiduciary duty to its client. That is, an investment advisor is held to the standard of a prudent expert in like circumstances. Furthermore and very importantly, an investment advisor, unlike a securities dealer, does not provide liquidity or market access to its clients, nor does it engage in principal transactions with them. In fact, the securities laws prohibit a registered investment advisor from engaging in principal transactions with its agent except in the most limited circumstances. A financial advisor is compensated for its advice, not for the risks associated with financial intermediation.

Despite these fundamental differences, the separate and distinct roles of securities dealers and investment advisors—and the respective standards applicable to their dealings in the institutional market—are often confused. They are confused because, first, securities dealers, in their roles as financial intermediaries and market participants, must, by definition, regularly describe and offer securities to institutional counterparties, quote prices, discuss and consult on investment strategies and perform research and analytical services. Indeed, the plethora of research services offered by securities dealers to institutional investors is a hallmark of our industry and markets. Indeed, institutional investors base their decisions as to which securities dealers they do business with to a significant degree on the amount and quality of research services offered. Consequently, securities dealers compete virtually as aggressively on research and information as on price. However, such services are in general generic, i.e., they are not tailored to particular counterparties. Second, many banks and securities firms that act as securities dealers also offer fee-based investment advisory services, either directly or through affiliated companies, in addition to their roles as securities dealers. But the fact remains that the two roles—that of securities dealer and that of paid investment advisor—are distinct. It is not appropriate—and it is certainly not efficient—to convert securities dealers into unpaid investment advisors to institutional counterparties who are in a position to retain professional advice.

The confusion over the respective roles of securities dealers and investment advisors, as well as existing market regulations, has resulted in a perception among some institutional investors that securities dealers should and do bear a level of responsibility for decisions made by investors. Indeed, the legal responsibilities of dealers with regard to investment decisions of institutional investors are somewhat cloudy. In practice, such responsibilities are often determinable only on a case-by-case basis, resulting in considerable confusion and risk for all parties.

PSA's views on the suitability obligations of securities dealers to institutional investors are based on several fairly straightforward principles:

- The market between counterparties in principal transactions is predominantly an arm's length market.
- Institutional clients are, by definition, investors who either have the expertise to make investment decisions on their own or have the resources and the responsibility to hire such expertise from outside.
- Institutional investors often execute transactions with many dealers and typically price-shop even on a single trade.
- Securities dealers that sell to institutional investors rarely have full knowledge of a counterparty's portfolio or the trading strategy being employed. Indeed, institutional investors view information regarding their portfolios and strategies as highly proprietary and confidential and often take affirmative steps to prevent dealers from obtaining such information.
- The best way to establish a clear understanding of responsibility is when both parties to a transaction document in writing the nature of their relationship.

RECENT EFFORTS REGARDING SUITABILITY

In recent months, several organizations have completed work on defining the respective responsibilities of securities dealers and institutional investors. This work can serve as a framework for policy-makers in crafting appropriate suitability statutes and rules.

In March, the Derivatives Policy Group (DPG), a group of representatives from six firms active in the markets for over-the-counter derivative instruments, released its "Framework for Voluntary Oversight." The DPG report was prepared with the cooperation of Securities and Exchange Commission (SEC) Chairman Arthur Levitt and Commodity Futures Trading Commission (CFTC) Chairman Mary Schapiro. In general, the DPG emphasized that the counterparties in derivatives transactions

conduct business at arm's length, and that "each counterparty has a responsibility to review and evaluate transactions and to obtain necessary information or professional assistance."[2] SEC Chairman Levitt recently commented on the recommendations contained in the DPG's report. Chairman Levitt said that "the report provides useful guidance for end-users as well as for dealers and intermediaries."[3]

In August, a group of financial industry trade organizations, including PSA, working under the coordination of the Federal Reserve Bank of New York, released its "Principles and Practices for Wholesale Financial Market Transactions." The document is designed to "confirm the relationship between [market] participants and to articulate a set of best practices with respect to over-the-counter financial markets transactions between participants."[4]

The "Principles and Practices" document clearly articulates the nature of the relationship between participants in the institutional capital markets. According to the "Principles and Practices," each market participant "should satisfy itself that it has the capability (internally or through independent professional advice) to understand and make decisions about its transactions."[5] Consequently, "a [market] participant should expect that its counterparty will assume that the participant has the capability to understand and make independent decisions about its transactions and will act accordingly."[6]

Finally, the National Association of Securities Dealers (NASD) recently submitted to the SEC for its approval the NASD's interpretation of the "Suitability Obligations to Institutional Customers" of NASD members. In general, NASD rules require that in recommending securities for sale to customers, NASD members "shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."[7] The NASD's recent proposed rule change and interpretive release was motivated by a provision in the Government Securities Act Amendments of 1993 that required the NASD to draft customer suitability rules for government and federal agency securities. In its proposal, the NASD has specified that its release would be "applicable not only to government securities but to all debt securities, excluding municipals."[8]

PSA recently filed formal comments on the NASD's latest proposal. A copy of our comment letter is attached as an appendix to this statement. Several aspects of the NASD's release are preliminarily noteworthy. The release recognizes that "it is difficult to define in advance the scope of a[n NASD] member's suitability obligation with respect to a specific institutional customer transaction recommended by a member."[9] The release also acknowledges the ambiguities in determining the suitability responsibilities of securities dealers with regard to institutional clients by noting that a determination of suitability "can only be made on a case-by-case basis taking into consideration all the facts and circumstances of a particular member/customer relationship, assessed in the context of a particular transaction."[10]

The NASD's proposed interpretation and rule change represent a positive development in several respects. First, the proposal clearly recognizes the very significant differences in dealer suitability obligations between retail and institutional investors. Second, the proposal acknowledges that for the purpose of determining dealer suitability obligations, in cases where a registered investment advisor makes investment decisions on behalf of retail or institutional investors, the dealer's obligation is to the investment advisor, and the determination of the obligation is based on information supplied by the investment advisor. Finally, the rule clearly states that a dealer's responsibilities regarding suitability arise only when an NASD member firm makes a recommendation for sale of a security. Despite these positive aspects of the NASD's proposal, however, it would still result in considerable confusion and uncertainty among securities dealers and investors regarding their obligations and responsibilities in institutional transactions.

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[2] Derivatives Policy Group, "Framework for Voluntary Oversight," March 1995, page nine.

[3] Arthur Levitt, Chairman, Securities and Exchange Commission, "Public Trust and Public Funds," remarks before the National Association of State Treasurers, October 16, 1995, page three.

[4] "Principles and Practices for Wholesale Financial Market Transactions," August 1995, as reprinted by the Public Securities Association, page one.

[5] "Principles and Practices," page eight.

[6] "Principles and Practices," pages eight and nine.

[7] Article III, Section 2, NASD Rules of Fair Practice.

[8] Securities and Exchange Commission, Proposed Rule Change by the National Association of Securities Dealers, Inc. (File No. SR-NASD-95-39), 60 Federal Register, October 24, 1995, page 54530.

[9] Securities and Exchange Commission, page 54532.

[10] Securities and Exchange Commission, page 54533.

All these efforts indicate that the participants in the financial markets recognize a need for clarity in the area of institutional investor responsibility and the suitability obligations of dealers. Each represents an approach to balancing dealer obligations and investor responsibility in a particular segment of the market. Against such a backdrop, a comprehensive legislative solution seems very desirable, not least because the ambiguities inherent in the current patchwork of rules results in unnecessary risk and uncertainty in the capital markets—which translates into less market efficiency and higher costs.

Principles of Suitability

PSA believes that devising straightforward, interpretable, workable and fair suitability obligations for dealers in the institutional market represents a difficult policy challenge. We welcome efforts by regulators, self-regulatory organizations (SROs) and others to devise suitability guidelines that recognize that institutional market participants should expect that their counterparties deal with them at arm's length.

In addition, any rules governing institutional suitability should embody the principle that investors, especially institutional investors, must bear responsibility for their decisions. Efforts to shift the consequences of bad investment decisions and losses to securities dealers carry ominous implications for our markets. A dealer must know with certainty that a transaction undertaken lawfully and in good faith is binding and that the responsibility for the performance of an investment in fact shifts from seller to buyer. A market where investors are permitted to reap the benefits of a rising market but are able to transfer losses incurred in a falling market back to the dealer who sold the securities is not appropriate. If institutional investors are protected from the consequences of their investment decisions by recourse to the firms with whom they dealt on the basis of an after-the-fact claim that they lacked the knowledge, competence or oversight to make an informed decision, the efficiency and stability of our markets will be substantially eroded.

Securities dealers should not be transformed into guarantors of the investments they sell, nor into insurers against loss or market volatility or against changes in an issuer's or counterparty's financial fundamentals. Indeed, paradoxically, such insulation against loss can only encourage inappropriate risk-taking by institutional counterparties with good reason to believe they will be protected from the consequences of being wrong. Investment losses in the financial markets are inevitable, and the discipline imposed by the risk of loss motivates careful decisions by wise market participants. Chairman Levitt has enunciated the fundamental principle that "all customers whether it's your neighbor down the street, your local municipality, or a large, international corporation must take responsibility for understanding what they are buying and how it fits their investment objectives." [11] We agree wholeheartedly with Chairman Levitt.

Early in the debate over the reauthorization of the Government Securities Act, in a statement before this subcommittee, PSA iterated several fundamental principles that should govern dealer suitability obligations to large, institutional investors. We said that suitability requirements should "hold institutional investors, whether public or private, to a high standard of competence and accountability for their investment decisions." [12] We also said that suitability requirements should "reflect the degree of control that a dealer has over an investor's account." [13] Because a dealer rarely has access to complete information regarding an institution's holdings or strategy, the dealer cannot be expected to be in a position to evaluate the appropriateness of each investment decision. The principles we espoused then are similarly applicable now.

This is not to imply that securities dealers are without responsibility in dealing with institutional investors. Dealers are appropriately bound to legal and ethical standards in facilitating transactions. They must be honest and deal in good faith. They must not mislead. Their calculations must be accurate. They must employ good-faith assumptions. They are, of course, liable for fraud. However, once these responsibilities have been met, a dealer should be able to rely on the certainty that once a security is sold, financial risk shifts to the buyer. As Federal Reserve Board Chairman Alan Greenspan has said, "markets function most efficiently when both parties to a financial transaction are free to enter into transactions at their own discretion, unhampered by any perceived need to serve the interests of their counterparties.... If discipline from incurring losses from mistakes were mitigated,

[11] Arthur Levitt, October 16, 1995, page four.

[12] Statement of Ronald Keenan, Co-chairman, Public Securities Association, before the Subcommittee on Telecommunications and Finance, Committee on Commerce, May 9, 1991, page six.

[13] Ronald Keenan.

vigilance would be relaxed.... I believe that we should start with the principle that parties to financial transactions are responsible for their own decisions and only use regulation to adjust the balance of responsibilities between the parties cautiously after the benefit has been clearly established."[14]

Section Two of H.R. 2131

PSA strongly supports the principle embodied in section two of H.R. 2131 regarding the respective responsibilities of dealers and institutional investors in capital markets transactions. This provision would create a statutory presumption against dealer liability for the investment decisions of a larger institutional client and would prohibit SRO rules from making dealers "responsible" for the investment decisions of institutional clients. The provision would apply to institutional investors with securities portfolios of $10 million or greater. Under H.R. 2131, counterparties would be free to negotiate the nature of their relationship, and document that understanding in writing, if there existed a mutual agreement that the dealer assume responsibilities that exceeded those implied by the traditional dealer role of market-access provider. The bill would make no changes to dealer suitability obligations to individual investors or to institutional investors with portfolios smaller than $10 million. The suitability provision in H.R. 2131 represents the simplest and most workable approach to establishing clear and distinguishable responsibilities for dealers and institutional clients. The provision would help to ensure that uncertainty and risk associated with ambiguity regarding the respective roles of parties to securities transactions do not ultimately threaten the efficiency and soundness of our markets.

The principle is fundamental. If a person is responsible for managing over $10 million of an organization's money, that responsibility should be taken seriously. If an organization's investment manager does not possess the personal expertise to accept that responsibility, he or she should hire someone who does.

PSA would support and advocate technical changes to section two of the bill to clarify the scope and effect of its language. For example, section two may imply that dealers are relieved from their obligations under the anti-fraud portion of the securities statutes with regard to recommendations of securities for sale to institutional clients. We feel strongly that the anti-fraud provisions should apply to dealers in recommending securities to any investors, including institutions. Dealers who, for example, make false or misleading statements in recommending securities for sale should be subject to strict enforcement measures. We also feel that it was not the intent of the bill's drafters to relieve dealers of their responsibilities under the anti-fraud provisions of the securities laws. In general, however, we are very supportive of the measure.

Securities Margin Requirements

"Margin" refers to the extent to which market participants may borrow in order to finance their securities holdings. Existing rules governing margin requirements are imposed under sections seven and eight of the Securities Exchange Act of 1934. It is widely accepted among regulators and market participants that current margin rules are antiquated and result in considerable market inefficiencies. For example, Fed Chairman Greenspan told this subcommittee just last week that, in comparing Congress' original objectives in applying margin rules and the effects of those rules today, "The Board believes that experience and regulatory changes during the six decades since the passage of the 1934 Act support the conclusion that margin regulation is not the best way to achieve those objectives."[15] Chairman Levitt said that "The [SEC] agrees that there is a need to reexamine margin requirements."[16] Although all parties to the debate over margin rules agree that reform is needed, as a member of one of the three firms that worked with the SEC to help develop a solution to problems associated with existing margin requirements, I want to underscore that I appear here today on behalf of PSA and not Morgan Stanley & Co., Inc.

The federal securities laws impose significant regulatory restrictions on extensions of securities credit. Under the 1934 Act, the Board has adopted four regulations relating to securities margin:

- Regulation T (applicable to broker-dealers)
- Regulation U (applicable to banks)

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[14] Statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, January 5, 1995, page three.

[15] Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Subcommittee on Telecommunications and Finance, Committee on Commerce, U.S. House of Representatives, November 30, 1995, page two.

[16] Arthur Levitt, November 30, 1995, page 12.

• Regulation G (applicable to all other lenders)
• Regulation X (applicable to borrowers)

Each of the regulations differs from the others in scope and manner of application. In addition, broker-dealers, unlike other lenders, are subject to separate initial and maintenance margin requirements prescribed by the securities self-regulatory organizations.

In addition, broker-dealers are currently prohibited from borrowing in the ordinary course of business except from (i) Federal Reserve System member banks, (ii) certain non-member banks, or (iii) another broker-dealer, against non-exempt equity securities listed or traded on a national securities exchange. Finally, broker-dealers are generally prohibited from extending, maintaining or arranging any credit for a customer on any non-exempt security which was part of a new issue, if the broker-dealer participated in the distribution of that security within 30 days of the transaction. This general prohibition is subject to exceptions for certain delayed delivery transactions.

The current patchwork of regulations governing margins has resulted in significant inefficiencies and competitive disadvantages:

- The existing statutory framework for margin regulation and the rules thereunder create substantial competitive disparities, both internationally and domestically. U.S. broker-dealers are at a significant competitive disadvantage to foreign firms, which are not subject to U.S. margin regulation, with respect to the terms on which credit can be extended or arranged for customers.
- The margin regulations applicable to broker-dealers are more stringent than those applicable to banks and other lenders. Accordingly, broker-dealers are disadvantaged with respect to their domestic competitors.
- The current regulatory scheme imposes needlessly complex requirements and results in significant compliance cost without commensurate public benefits.
- The limitations imposed on extending or arranging credit against new issues of securities unnecessarily restrict the ability of broker-dealers to participate in beneficial capital-raising activities by providing financing to customers in connection with distributions of securities.

Section four of H.R. 2131 would eliminate margin requirements for all fixed income securities transactions and all equity transactions with institutional creditors, reduce restrictions on a dealer's ability to borrow, eliminate new issue lending restrictions, and prohibit SROs from adopting rules that are more restrictive than, or inconsistent with, those of the Federal Reserve.

In addition to the margin reform proposals contained in Chairman Fields' bill, the SEC recently presented to Congress proposed legislation that attempts to enhance the competitiveness of U.S. securities firms by (i) removing restrictions on the sources of financing for broker-dealers; (ii) shifting the authority to set margin restrictions for most debt securities to SROs; (iii) removing margin restrictions on lending to broker-dealers that do a substantial public business or for market making or underwriting activity; and (iv) granting the Board, the securities exchanges, and other SROs the authority to establish appropriate margin provisions to address issues of systemic risk and investor protection.

PSA strongly supports the margin provisions in Chairman Fields' bill. We are also encouraged by the SEC's initiative on margin reform as well as proposals put forth recently by the Federal Reserve Board. The SEC's and Fed's proposals reflect an important recognition that the current system of margin regulation is fundamentally flawed, and they represent thoughtful alternative approaches.

Nevertheless, PSA believes that the margin provisions in H.R. 2131 represent the best means of addressing problems with current margin rules. For example, although the SEC legislation substantially expands the scope of marginable debt securities, it does not prevent the SROs from creating regulatory constraints that are at least as restrictive as present law. WePSA strongly believes that any benefit afforded by federal margin reform would be illusory unless a provision similar to the one in Chairman Fields' bill is enacted which restricts SROs' ability to impose more burdensome margin regulations. We also appreciate the efforts of the Federal Reserve Board to significantly revise Regulation T governing margin requirements for broker-dealers. However, like the SEC and the Fed, PSA feels strongly that regulatory changes alone will be insufficient to address the numerous problems inherent in the current system.

Creation of National Securities Markets

Each of the federal securities statutes contains provisions that preserve generally the authority of the states to regulate matters relating to securities transactions and the activities of market participants. Accordingly, offers and sales of fixed income

securities and the brokers and dealers who sell them, are subject to securities regulation at both federal and state levels.

In the case of public offerings of securities, the federal securities laws are designed principally to ensure that prospective purchasers are provided with all "material" information about the issuer and the securities. The theory of the federal securities laws is that investors are protected if full disclosure of all material information is made, and that once such disclosure is made investors should decide for themselves the desirability of purchasing the securities.

Each of the 50 states has some form of state securities or "blue sky" laws, most of which impose requirements different from those of the federal securities laws in some or all respects. Unlike the full disclosure approach of the federal securities laws, a substantial number of the state securities laws are designed to protect investors through the application of specific substantive, qualitative standards to an issuance of securities, sometimes referred to as "merit" regulation. Approximately one-half of the states have adopted, by statute or regulation, provisions relating to the qualitative terms that publicly-offered debt securities must meet. Included among such states are some of the more populous states, such as California, Massachusetts, Ohio, Pennsylvania, Texas and Wisconsin. While there is some overlap among the states' provisions, they are far from uniform. Compliance with a state's provisions is generally a prerequisite to offering the securities for sale in such state.

Unlike the securities registration process, the states do not have a different philosophical approach to broker-dealer registration than the federal system.

The greatest burden on the securities markets caused by the current dual regulation of the public sale of debt securities exists in the case of such securities issued by companies whose equity securities are neither listed on a major national stock exchange nor included for trading on the Nasdaq Stock Market ("listed security"), where such debt securities are sought to be sold to the retail market. The state laws uniformly exempt from state registration sales to specified "institutional buyers", and virtually all the state laws exempt from registration the offering of securities, including debt securities which are listed or senior to the issuer's class of "listed securities."

The basis for the "listed securities" and "senior to listed securities" exemptions is that issuers of listed securities are generally the more seasoned and substantial issuers. Notwithstanding this fact, the states of California and Wisconsin apply significant further requirements to the offer and sale of unlisted debt of such issuers. In California, unlisted debt securities will qualify for the exemption only if they are senior to a listed security of the issuer and rated by Standard & Poor's Corporation as AAA, AA, A or by Moody's Investors Services as Aaa, Aa, or A or Baa. In Wisconsin, unlisted debt securities will qualify for the exemption only if they are equal in rank or senior to a listed security of the issuer and the issuer has net income equal to at least 125% of its combined annual interest and dividend expense. The effect of these provisions is that many debt public offerings are not available to investors other than institutional investors in California and Wisconsin because the issuers and underwriters are discouraged by the administrative burden and expense of registering the securities and/or are unable to comply with the exemptions.

In cases of public offerings of debt securities of issuers without a class of listed securities, the regulations of the approximately 24 states having specific provisions regarding debt securities do, among other things, one or more of the following: (i) require the use of a trust indenture meeting the requirements of the Federal Trust Indenture Act (even in cases where such an indenture would not be required by the Trust Indenture Act itself); (ii) preclude the sale of debt securities by "unseasoned" companies or companies in the promotional or development stage; (iii) require specific sinking fund provisions; and (iv) require that the issuer satisfy various specified cash flow, earnings or debt coverage tests over specified periods. Again, these provisions have the effect of precluding the sale of certain issuances of securities in various states.

Some states impose burdensome requirements on the registration of broker-dealers. For example, New York's blue sky laws bring an issuer within the definition of a "dealer" and require registration by an issuer as a dealer in connection with an offering of securities even if the offering is made by a registered broker-dealer in other than a firm commitment underwritten offering. Moreover, broker-dealers are subject to "spot" on-site audits by both state and federal securities agencies.

In addition, the requirements for registration of broker-dealers on a state-by-state basis do not recognize the national nature of our business economy or the mobility of our society, both of which can require brokers to deal with the clients across state lines.

Under section three of H.R. 2131 states generally would be pre-empted from regulating any securities offering that is registered under the Securities Act of 1933 or exempt from registration under such Act.

States would, however, be permitted to continue to require (i) the filing with state regulatory authorities, solely for notice purposes, of any registration statement or related documents filed with the SEC in connection with a securities offering, (ii) a consent by the issuer to service of process in such state and (iii) the payment of filing fees, except that no such filing, consent or fee would be permitted with respect to any offerings of securities that are of the same class as securities, or senior to such a class, listed on NYSE, AMEX or designated for trading on Nasdaq Stock Market or that will be so listed or designated upon completion of the offering.

The states would retain the right to enforce antifraud provisions in connection with the securities offerings. In retaining this state authority, the bill recognizes the important role that state securities regulators play in maintaining safe and honest markets.

H.R. 2131 would generally pre-empt the ability of the states to require the registration, licensing or qualification of any broker or dealer who is (i) registered with the SEC, (ii) exempt by rule or order by the SEC from such registration, (iii) an issuer, (iv) a member of a national securities exchange or (v) certain other persons associated with persons exempted under the foregoing clauses (i), (ii) and (iv).

However, states would be permitted to require registration, licensing or qualification of brokers or dealers, other than issuers, if the state performs its registration, licensing or qualification procedures through a central registration depository system operated by a national securities association and such requirements are substantially the same as the SEC's requirements. The proposed legislation does not limit fees charged by state regulators in connection with any such registration, licensing or qualification requirements. No state would be allowed to establish broker or dealer capital or books and records requirements different from the SEC's requirements

PSA believes that the proposed federal securities law reform legislation that generally preempts state securities law regulation regarding securities and broker-dealer registration is a sound proposal to eliminate unnecessary, duplicative and costly regulation. We agree with Chairman Levitt that with regard to registration requirements, for example, "Congress, federal and state regulators, and industry participants [should] work together to determine how best to reallocate responsibilities between the federal government and the states with respect to securities registration." [17] We are also supportive of the effort recently announced by the SEC and the North American Securities Administrators Association (NASAA) to examine the relative roles of federal and state securities regulators and recommend ways to better coordinate and streamline federal and state securities rules. We look forward to the SEC's and NASAA's conclusions and recommendations.

Prospectus Delivery

PSA believes Congress should give the SEC enhanced authority to adopt additional exemptions to the prospectus delivery requirements in the Securities Act of 1933 (the "Securities Act"). In particular, the SEC should be empowered to establish exemptions for delivery to prospective investors of terms sheets, scenario analyses and similar materials for fixed income and structured securities. As Chairman Levitt has noted, "the existing system [of prospectus delivery requirements] does not serve either issuers or investors as well as we would like." [18]

The 1933 Act establishes a series of formal requirements relating to the delivery of prospectuses to investors in connection with registered public offerings of securities. Subject to certain limited exceptions, the current regulatory structure does not permit an underwriter to send any written materials to an investor, prior to the time when a final prospectus for the offering has been sent to the investors. The SEC's general exemptive authority to permit the distribution of written materials to investors prior to the time when the final prospectus is sent is unclear.

In a number of contexts, particularly involving asset backed or structured securities and registered offerings conducted under the SEC's "shelf" registration rules, it is beneficial for investors to be able to obtain from broker-dealers written materials that provide information about an offering prior to the time when a final prospectus is available. For example, the ability of broker-dealers to provide prospective investors with various types of computer-generated analyses plays a key role in the interactive process through which broker-dealers structure asset backed securities offerings to meet the investment needs of their customers.

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[17] Arthur Levitt, November 30, 1995, page seven.

[18] Arthur Levitt, November 30, 1995, page 14.

The 1933 Act framework for prospectus delivery does not readily accommodate the interactive process that has developed in the market for mortgage and other asset backed securities. At the same time, the SEC's flexibility to adapt the statutory framework to this evolving market has been limited to matters that can be addressed on a narrowly tailored basis through no-action letters. In the context of asset backed offerings under the shelf rules, the SEC staff has granted no-action relief permitting broker-dealers, subject to certain conditions, to distribute (i) terms sheets describing the structure of or collateral for an offering and (ii) computational materials that provide investors with information about the interest rate sensitivity and cash flow characteristics of a class of securities under a variety of possible scenarios.

The current no-action regime established by the SEC is inadequate as a long term solution. The current conditions to the no-action relief impose a number of particularly burdensome filing requirements on both broker-dealers and issuers. Moreover, existing no-action letters, which apply only in the limited context of shelf-registered asset backed offerings, provide no relief to other types of offerings (such as structured securities) in which it may be equally desirable to provide investors with information about an offering prior to the time when a final prospectus is available.

The current 1933 Act regulatory structure also does not readily address issues relating to the distribution of information to investors via electronic media. While the SEC has granted limited no-action relief relating to the transmission of certain "electronic prospectuses," greater flexibility under the statute is needed in order to address issues relating to the use of electronic communications in connection with securities offerings.

Section six of H.R. 2131 includes a number of reforms relating to prospectus delivery. It would (i) amend the definition of "prospectus" to exclude a confirmation of sale, (ii) reduce prospectus delivery obligations such that the delivery of securities to a customer would need to be accompanied or preceded by delivery of a final prospectus only if the purchaser or prospective purchaser has requested a prospectus, and (iii) grant the SEC general authority to exempt any person or prospectus from the requirements of the securities laws.

We are encouraged by efforts underway at the SEC to examine prospectus delivery requirements and consider streamlining the process. We hope that these efforts bear fruit. However, we feel that section six of H.R. 2131 represents the best approach to the issue. PSA strongly supports the legislation's efforts to facilitate investor communication in an efficient and cost-effective way.

Other H.R. 2131 Provisions

Although PSA has not adopted formal positions on all provisions of H.R. 2131, we strongly support the following sections of the bill designed to improve the efficiency of the U.S. market regulatory structure.

- Section seven of H.R. 2131 would grant the SEC general rulemaking authority to exempt securities from the registration requirements of the securities laws if it finds such exemption is consistent with the public interest and the protection of investors. The Bill would also raise from $5 million to $15 million the amount of securities that may be offered pursuant to the Securities Act exemption for "small offerings." PSA strongly supports this provision.
- Section eight of H.R. 2131 would add a provision to each of the Securities Act, Exchange Act, Investment Advisers Act and Investment Company Act requiring that, whenever the SEC is required to consider or determine whether an action is consistent with the public interest or the protection of investors (or both), the SEC also consider or determine whether the action will promote efficiency, competition, and capital formation. PSA supports the legislation, subject to a clarification that we oppose any bureaucratic process (e.g., environmental impact statement) implemented to facilitate the statutory goals that places undue burdens on SEC staff.
- Section 12 of H.R. 2131 would require the SEC to designate a single SRO examining authority for each broker-dealer. The Bill is intended to preclude examinations by multiple SROs. PSA strongly supports the Bill's efforts to avoid duplicative examinations. The Bill's objective is consistent with the PSA's objective of avoiding duplicative examinations of broker-dealers, but does not address coordination of SEC examinations with those conducted by the SROs.
- Section 14 of H.R. 2131 would repeal the Trust Indenture Act of 1939. PSA supports this provision, subject to inclusion of statutory provisions of a procedural nature that would arise in the case of a bond default in order to protect the interests of smaller bondholders.

Summary

Our capital markets are the safest and most efficient in the world. Questions regarding the roles and responsibilities of securities dealers and institutional investors, however, plague regulators and market participants. On an increasingly regular basis, institutional investors with large portfolios—sophisticated, professional investors—seek to assign the responsibility for bad investment decisions to dealers whose only role has been simply to facilitate market access. This trend, if it continues, will threaten the efficiency and stability of our markets. Ultimately, it is incumbent on policy-makers to establish a playing field where securities firms and banks are not unduly burdened with the costs of bad financial decisions and losses which investors will regrettably but inevitably suffer. Professional investment managers cannot and should not be protected from the consequences of their decisions by recourse to financial intermediaries.

As discussed above, PSA strongly believes that any benefit afforded by federal margin reform would be illusory unless a provision similar to the one in Chairman Fields' bill is enacted to restrict SROs' ability to impose more burdensome margin regulations. We also believe that the bill's provision to generally pre-empt state securities law regulation regarding securities and broker-dealer registration is a sound proposal to eliminate unnecessary and costly regulation. Finally, we believe Congress should give the SEC enhanced authority to adopt additional exemptions to the prospectus delivery requirements in the Securities Act of 1933.

In sum, PSA wishes to commend Chairman Fields and other members of the Subcommittee for leading a vital national dialogue on ways to improve securities regulation. The above provisions, and many others in H.R. 2131, would vastly improve the efficiency of our securities markets, and help to ensure our nation's place as the world's preeminent business venue.

Mr. FIELDS. The Chair would now recognize Mr. John Gaine, General Counsel, the Managed Futures Association.

STATEMENT OF JOHN G. GAINE

Mr. GAINE. Thank you, Mr. Chairman and members of the subcommittee. My name is John Gaine. I am General Counsel and Director of Government Relations of the Managed Futures Association.

MFA is a not-for-profit national trade association representing the managed futures industry. Our membership is primarily composed of commodity pool operators and commodity trading advisors whose security offerings and business operations are comprehensively regulated under the Commodity Exchange Act by the Commodity Futures Trading Commission. However, virtually all commodity pools are organized as limited liability entities which issue securities. The offer and sale of their interests are also subject to both the Federal and State securities laws.

I am here today on behalf of MFA and its many members to applaud the Chairman and subcommittee for addressing the issue of the appropriate interrelationship of the State and Federal securities laws at this time.

The goal of Section 3 of H.R. 2131, entitled Creation of National Securities Markets, which is the focus of my testimony, is to rationalize and streamline the overlapping, unnecessary, internationally anticompetitive and burdensome effect of having 51 separate State and securities laws applicable to the offering of the securities of the same single entity, an offering which is extensively regulated at the Federal level.

Public commodity pools are a significant and rapidly growing component of the U.S. financial services industry. These investment vehicles offer important portfolio diversification and professional risk management with the benefit of limited liability to

smaller investors who otherwise would have no access to professional management of their assets in the futures market.

Although the States are preempted from regulating the markets in which they trade, few financial products are as burdened in their offering process by the State blue sky process as are commodity pools. For a generation, State qualification of commodity pool offerings have been marked by delays, inefficiencies and both out-of-pocket and opportunity costs, with no appreciable counterbalancing investor benefits.

Although their actual operations are outside State jurisdiction, the pools have been compelled to focus the bulk of their startup efforts on obtaining State registration for their securities offerings. It is, ironically, the State securities regulators, neither of the Federal agencies, who have primary jurisdiction, which cause the greatest delay and burden in commodity pool offerings.

In a typical public offering of a commodity pool, SEC and CFTC clearance is obtained in no more than approximately 6 weeks, often sooner. In the States, on the other hand, final clearance, if in fact ever obtained, can require as much as 4 months or longer. Furthermore, it is not just the delay which is costly and burdensome but, more importantly, the uncertainty and arbitrariness of the process. Different States and different examiners from the same States apply different substantive standards in deciding which pools to approve.

Nor is this any fault of the State examiners and administrators but rather the inevitable result of having such a large number of independent regulators reviewing an offering. The pools are an excellent case in point of the extent to which the U.S.'s complex and duplicative system of securities regulation serves to increase transaction costs and discourage the creation and offering of innovative financial products. This legislation is a major step forward in addressing this problem.

Commodity pool filings using a particular structure have in the past routinely been accepted in some States but rejected in others, and even sponsors with pools initially accepted in a given State have had substantially similar or identical offerings refused registration a few months later. Why should an investor in one State be denied the opportunity even to consider an investment in a pool available to investors in 48 other States and, I might add, readily available abroad?

Even if the various States do in fact clear an offering not only do they commonly require widely differing additional disclosures—again, after these disclosures have already been exhaustively reviewed by both the SEC and CFTC—by way of cumbersome stickers or supplements, but some even insist upon their idiosyncratic form of subscription agreement. When one considers that a major pool offering will print 200,000 to 400,000 prospectuses, one can begin to appreciate the costs involved in customizing disclosures to the tastes of multiple State regulators.

Perhaps even less justifiable is the crazy quilt of suitability standards imposed by the different jurisdictions.

I will not presume to take more of the committee's time continuing to recite specific examples of the disparate and apparently quite arbitrary treatment of commodity pools among the different

States. Suffice it to say that instances are myriad and the effect materially adverse. The consequences of State review has been a dramatic contraction in the number of public commodity pool sponsors at the same time that investor interest is burgeoning.

Equally important, the opportunity costs of being unable to schedule an offering with any certainty are frankly criminal. As a result of these enormous costs, the public pool industry has now become concentrated in a very limited group of major national firms with a capital to absorb the entry barrier created by blue sky costs. Smaller local and regional firms are shut out of this market. The merit review process has reduced competition as well as stifled innovation.

Commodity pools present a very hard case for justifying continued State jurisdiction. Already under the scrutiny of two major Federal agencies, with their underlying activity explicitly preempted from State jurisdiction, the pools still must labor their way through the States in a capital formation process. Sponsors turn offshore, and many of the best American advisors provide their services exclusively to foreign investors.

No major industrial nation has a complex two-tiered regulatory structure such as we have in the U.S.

In closing, we would also mention that MFA fully supports the remainder of Section 3 of the bill providing for uniform national registration of securities' industry professionals. As I described at the outset, MFA's members are primarily commodity pool operators and commodity trading advisors registered with the CFTC and the National Futures Association. CPOs and CTAs, as well as the commodity brokers through which they execute trades, are subject to one national uniform registration system with no State involvement. This scheme for commodity professionals has been in place since 1975 and has worked efficiently and well, balancing investor protection and the needs of the industry. Any effort to recast the securities industry along these lines would be very welcome.

Mr. Chairman, thank you for the opportunity to appear. We strongly support your efforts to create a national securities market. I would be happy to respond to any questions.

[The prepared statement of John G. Gaine follows:]

Prepared Statement of John G. Gaine on Behalf of the Managed Futures Association

Mr. Chairman and members of the Subcommittee, my name is John Gaine, General Counsel and Director of Government Relations of the Managed Futures Association (MFA). MFA thanks the Subcommittee for the opportunity to present its views on H.R. 2131—"Capital Markets Deregulation and Liberalization Act of 1995".

The Managed Futures Association is the not-for-profit national trade association representing the managed futures industry. The MFA is a membership organization of professionals who provide investment and other services to clients on a global basis. It has approximately 500 members who are responsible for the discretionary management of the vast majority of the estimated $20 billion currently invested in managed futures products, including commodity pools and managed futures accounts. MFA is governed by an elected board of directors and has offices in Washington, D.C. as well as California.

The objective of the MFA is to enhance the image and understanding of the industry, to further constructive dialogue with regulators in pursuit of regulatory reform, and to improve the communication with, and training of, the Association's members through effective conferences and communications programs.

MFA's membership is primarily composed of commodity pool operators and commodity trading advisors whose business operations are regulated under the Com-

modity Exchange Act by the Commodity Futures Trading Commission. The Commodity Exchange Act oversees and monitors the business activities of commodity pool operators and commodity trading advisors through registration, disclosure, recordkeeping, and reporting requirements, and together with the National Futures Association (the national self-regulatory body of the futures industry) is their primary regulator. However, as most commodity pools are organized as limited partnerships, the offer and sale of their interests is subject to both the Federal and state securities laws (although the operations of such pools has nothing to do with securities). I am here today on behalf of MFA and its many members to applaud the Chairman and Subcommittee for addressing the issue of the appropriate roles of the state and federal securities laws. These are issues of fundamental importance to the managed futures financial sector.

H.R. 2131 seeks to rationalize regulations applicable to our industry and to streamline the overlapping, unnecessary, internationally anticompetitive and burdensome effect of having 51 separate state and federal securities laws applicable to the offering of interests in just one entity. Public commodity pools are a significant and increasingly essential part of the U.S. financial services industry. According to Managed Account Reports, in 1983 there were approximately 32 public funds with $249 million in assets. Today there are approximately 122 public funds with $2.2 billion in assets. These investment vehicles offer important portfolio diversification and professional risk management to smaller investors who otherwise would have no access to professional management of their assets in the futures markets. The U.S.'s complex and duplicative system of regulation serves merely to increase transaction costs and discourages the creation and offering of products in response to changing market conditions. For the U.S. to remain competitive in the rapidly changing international markets and not to lose its market share of that vast business commensurate with the U.S.'s overall economic powers and financial sophistication, its complex and expensive regulatory structure must be substantially streamlined. *This legislation is a major step forward.*

The markets in which commodity pools invest are global and are subject to extensive federal regulation. It makes no sense to have differing substantive regulation in each of 51 states. An investor in Texas investing in the same product should receive the same offering document as an investor in New York. There is no logical rationale for distinguishing these global products according to the regional location of their investors.

My testimony today will address primarily Section 3 of H.R. 2131—entitled "Creation of National Securities Markets". The goal of a national unified system of regulation is laudable and necessary. Then SEC Commissioner Mary Schapiro recognized this fact in a letter to Senator Dodd in April of 1991. She stated:

> "The second principal reason for enactment of the exclusivity provision was to protect exchange-traded futures from interference by state regulations and the potentially adverse and costly impact of compliance with 51 different regulatory schemes. Congress recognized and repeatedly reaffirmed the value of a nationally uniform body of standards governing futures trading coupled with state antifraud enforcement."

Unfortunately, U.S. commodity pools have been a case study proving the wisdom of Ms. Schapiro's call for a uniform regulator. Few financial products have been as burdened by the state Blue Sky process as commodity pools. The history of qualification of commodity pool offerings in the various states is not happy. It has been marked by delays, inefficiencies and costs with no appreciable counter-balancing public benefits. Although trading exclusively in markets which the states are preempted from regulating and subject to the jurisdiction of two independent federal agencies, the SEC and CFTC, the pools have been compelled to focus the bulk of their start-up efforts on obtaining state registration for their securities offerings.

In a typical public offering of a commodity pool, SEC and CFTC clearance is obtained in no more than approximately six weeks. Indeed, the SEC has only recently streamlined its review process for the pools (recognizing their doubly regulated character) so that an even quicker federal review process is anticipated. In the states, on the other hand, final clearance, if obtained, can require as much as four months or longer. Furthermore, it is not just the delay which is costly and burdensome, but the uncertainty and arbitrariness of the process. Because it is impossible to predict when certain important states will "clear," it is impossible to predict when an offering can commence. This is more than simply an inconvenience. In the larger securities firms, the offerings of different products are carefully scheduled, and if a pool misses its allotted "time slot," it may be a matter of months before it can get back on the calendar.

The organizational costs—which are borne by the investing public—of a large public pool offering will typically range from approximately $500,000 to $1,000,000. Of

this, perhaps $300,000 will relate to legal fees and expenses, and of that figure, $100,000 or more will be directly related to the process of responding to the often multiple rounds of questions and comments received from the merit review states—and all this in the context of an offering which has been cleared in Washington by two different and independent agencies.

The substantial costs and uncertainty of dealing with 51 different regulatory jurisdictions is one of the principal, if not the single most important, reasons that the public pool industry has now become concentrated in a very limited group of major national firms with the capital to absorb the entry barrier created by Blue Sky costs. The merit review process of a number of states has stifled innovation and the development of new products. Smaller local and regional firms are shut out of this market. We do not suggest by any means that this situation is the fault of the state regulators. On the contrary, whatever the quality of the state regulatory personnel (which in our experience has generally been high), it is a systemic problem to require a prospectus already cleared by agencies expert both in disclosure and in the field in which the issuing pool will operate also to be reviewed by the "merit review" states of which there are approximately 25—adding a layer of substantive review to the stringent CFTC/SEC disclosure oriented review process. Any regulatory system which has that many "chefs in the kitchen" will inevitably result in waste, delay and industry contraction. The situation is particularly acute in the commodity pool context, as our different "chefs" have entirely different views on how to cook—the state imposing substantive restrictions, the SEC and the CFTC focusing on disclosure.

Expense and delay are not the only negatives of multiple merit review: substantive inequities and arbitrariness also result. The NASAA Administrators spent years promulgating Guidelines relating to the substantive terms of commodity pools, but not only does the pace of change in the industry inevitably outpace the states' ability to adapt the Guidelines, but also the Guidelines are applied with widely varying degrees of strictness in different jurisdictions. For example for years, it was impossible to clear any commodity pool offering in certain major states due solely to state internal administrative policy (no statutes were involved), while at the same time other types of significantly more speculative offerings were routinely approved. Today, Minnesota and South Dakota will not admit pools which employ certain forms of incentive fees, while these fee structures (aimed at reducing routine costs payable irrespective of profitability) are otherwise universally accepted. Why should an investor in one state be denied the opportunity even to consider an investment in a pool which is available to investors in 48 other states? Furthermore, the application of the substantive provisions is not necessarily consistent. Filings using certain structures have in the past been accepted in a given state only to have substantially similar or identical offerings refused registration a few months later. Again, we do not mention this by way of criticizing the state regulators, but rather by way of pointing out the massive inconsistency and "regulatory function" which inevitably result from having more than 25 independent regulators to satisfy, in addition to those in Washington.

Even if the different states do in fact clear an offering, they frequently do so on widely different terms. Not only do different states require widely differing additional disclosures (again, after these disclosures have been exhaustively reviewed by both the SEC and the CFTC) by way of cumbersome "stickers" or supplements, but some even insist upon their idiosyncratic form of subscription agreement. When one considers that a major pool offering will not infrequently print 200,000 to 400,000 prospectuses, one can begin to appreciate the cost involved in customizing disclosures to the tastes of multiple state regulators.

Perhaps even less justifiable is the crazy quilt of suitability standards imposed by the different jurisdictions. The NASAA Guidelines stipulate a minimum suitability requirement of $150,000 net worth or $45,000 net worth and $45,000 annual gross income. In a recent public offering, 15 states applied the Guidelines standards; 10 higher standards; and the rest a lower standard. One major state has recently suggested a suitability standard of as high as $500,000 "liquid" (i.e. exclusive of home, furnishings and automobiles) net worth to invest in a pool for which the minimum investment was only $5,000.

There is little point in reciting examples of disparate treatment among different states: redemption charges, limits on management and incentive fees, interest income, limited partners' voting rights, different forms of "principal protection" structures, fund names, indemnification—the list of issues on which the states have diverged is extensive, and the point is obvious. How can one hope to foster a national securities market when issuers must contend primarily not with the national, but with the literally dozens of autonomous and inconsistent state regulatory jurisdictions? Any system in which innumerable different jurisdictions are permitted to im-

pose their individual substantive as well as disclosure standards on an offering represents a "balkanization of regulation" antithetical to any sort of national market.

We emphasize that we do not, and would not, suggest that states should not continue to have powers to prosecute fraud and other police activities within their borders. On the contrary, we feel that a redeployment of Blue Sky resources from the independent and duplicative review of prospectuses already twice reviewed in Washington to a focus on misconduct and violations of law would be most welcome. Our point is much narrower and simpler: if Congress continues to *permit* the states independently to regulate pool offerings, a significant number of states inevitably will and the Blue Sky entry barrier will continue to choke off the U.S. public pool industry. This fact is borne out quite clearly in the history of the last 20 years. The legislative history of the 1974 amendments to the Commodity Exchange Act contained language quite clearly indicating that the states were to be preempted from reviewing commodity pool offerings. As will be obvious from the above, quite the contrary was—in the absence of an explicit provision—the result. It is a natural fact of government in this country that that which is permitted to be regulated will be; in the case of the pools, we must either say "no" to multiple independent regulatory jurisdictions or to a national market system.

Commodity pools present a very hard case for justifying continued state jurisdiction. Under the review of two major federal agencies, with their underlying activity explicitly preempted from state jurisdiction and the subject of additional ongoing review by both the CFTC and the National Futures Association, they still must labor their way through the states. The result: most do not. Sponsors turn offshore, and many of the best American advisors provide their services exclusively to foreign investors. The "flight offshore" and proverbial "uneven playing field" are perhaps nowhere as apparent as in the case of commodity pools—a result which is particularly ironic and disheartening as the United States is where both the futures markets and commodity pools were born and developed.

No major industrial nation has a complex two-tiered regulatory structure such as we have in the United States. In fact the EU through its Directives is going toward a system of cross-border simplification and uniformity—reflecting the global nature of these markets. The United States commodity pool industry deserves a single source of regulation over its offerings, and that source can only be the federal government—the SEC and the CFTC. The industry cannot afford to deal with so many jurisdictions in attempting to market its products to United States investors, who simply happen to reside in different states.

MFA offers the following comments with respect to the remainder of Section 3 of the bill relating to national uniform registration provisions governing securities' industry professionals. MFA's members are primarily commodity pool operators and commodity trading advisors registered with the CFTC and the National Futures Association. CPOs and CTAs (as well as the commodity brokers through whom they execute trades) are subject to one national uniform registration system with no state involvement in the process. This regulatory scheme has been in place since 1975 and has worked efficiently and successfully in protecting the public. Any efforts to conform the securities industry registration process to a national uniform system would from our experience make sense.

In conclusion, Mr. Chairman, we thank you for the opportunity to appear, strongly support your efforts to create a national securities market and would be happy to respond to any questions you or members of the Subcommittee might have.

Mr. FIELDS. Thank you, Mr. Gaine.

Mr. Fink, President of the Investment Company Institute.

STATEMENT OF MATTHEW P. FINK

Mr. FINK. Thank you, Mr. Chairman. I am pleased to be here this morning to testify on those provisions in H.R. 2131 that would redefine the roles of the Federal Government and the 50 State governments in the regulation of mutual funds. This is a very important and very timely initiative, and it affords the first opportunity in half a century to revise a system in the interests of 40 million fund shareholders.

The mutual fund industry has always supported strong Federal regulation and a well-funded SEC because we know that history demonstrates that strong Federal regulation and a well-funded

SEC are essential to keeping public confidence in the mutual fund industry. We also believe there is a very important role for State securities regulators. But we are absolutely convinced that a new and different division of labor between the Federal Government and the State securities regulators would better serve investors than the current system.

Today virtually every one of the 5,000 mutual funds, virtually every one of them, is offered in all 50 States. The simple mobility of American investors who move State to State, the use of technologies to reach investors, the coverage of mutual funds by the national media, these and other factors make mutual funds a national business.

As befits a national industry, mutual funds are extensively regulated at the national level by four separate securities laws, notably the Investment Company Act of 1940, which both sets disclosure requirements and detailed requirements on what a fund can and cannot invest in.

Every mutual fund, all of these 5,000 funds, no matter where it is incorporated, where it is physically located or where its shareholders live, is subject to one Federal standard set by the SEC. But, in addition to this, mutual funds must comply with regulations in any State where they offer their shares—in other words, in all 50 States.

These regulations differ significantly from State to State. We have identified 18 different approaches taken by the States today to mutual fund regulation. These differences make a bewildering patchwork quilt of inconsistent regulation.

Now, 18 States grant some form of exemption to mutual funds. Many of the other States, however, frequently comment on mutual fund prospectuses which have already cleared the SEC and, on top of this, eight or so States also impose restrictions on what a fund can and cannot invest in, restrictions that differ from Federal law.

Mr. Klink earlier noted that Pennsylvania does not review mutual fund prospectuses or impose investment restrictions. I think that is correct. But other States do. And under the system we have an idiosyncratic requirement by a single State that often affects investors in all States. That is because a fund's portfolio must be managed in the same way for investors, wherever they reside; and, therefore, if one State imposes a portfolio restriction and a fund is obliged, as it usually is, to sell in that State, that single State dictates fund investment policy for investors throughout the Nation.

I don't think that this system serves the interests of 40 million fund investors. It duplicates and often undermines the SEC's initiatives to improve investor protection.

One reason fund prospectuses are so detailed and complex and difficult to read is because you have 51 different regulators feeding in. It hinders innovations permitted by Federal law that would benefit fund shareholders and that have been approved by the SEC and imposes undue compliance burdens and costs on 500 mutual fund families; and it—probably most seriously, it takes State resources away from the area where they are needed, the cop on the beat.

The mutual fund industry has devoted years, 50 years, in attempting to remedy this problem at the State level. We have

worked with individual States, and we have worked with NASAA. Every one has acted in good faith, but the 50-year history tells us that this problem cannot be solved at the State level because one State causes a national problem. A congressional solution is needed.

We commend NASAA for establishing a task force to review the general issue of Federal and State securities regulation, but there is no need for you to delay congressional action in the mutual fund area pending the outcome of the NASAA study. That is because, as my written testimony gives in great detail, the issue of Federal and State mutual fund regulation has been studied for years; and there are literally scores of reports, law review articles, NASAA studies, that have been issued.

The facts are on the table. A consensus has emerged; and the solution, I submit, is clear. Specifically, the review of mutual fund prospectuses and advertisements should be lodged exclusively at the Federal level with the SEC and the NASD, and restrictions on mutual fund portfolio investments should be established exclusively at the Federal level.

On the other hand, the very valuable role that States play in other aspects of securities regulation, such as enforcement and sales practices and education, should be preserved; and, therefore, the mutual fund industry in no way objects to continuing to pay States' registration fees and making filings in the States.

Chairman Levitt of the SEC, a leading consumer advocate, has proposed this very solution; and last week in testimony before this very subcommittee he stated that such a State Federal system could be restructured in this manner, quote, without in any way compromising investor protection.

This approach would benefit investors throughout the Nation by establishing a uniform national system of regulation in which the resources of the SEC and the States are allocated in a sensible manner toward investor protection. And this is not just a theoretical model. About a dozen States have already amended their own State laws to do this model. They don't review fund registration statements. They collect fees and they pursue fraud, and that is what I believe Mr. Klink was referring to as what happens in Pennsylvania.

By enacting such a scheme nationwide, Congress can ensure that 40 million investors, located throughout the Nation, receive the full benefits of this very rational system of regulation. Thank you.

[The prepared statement of Matthew P. Fink follows:]

Prepared Statement of Matthew P. Fink, President, Investment Company Institute

I. INTRODUCTION

My name is Matthew P. Fink. I am President of the Investment Company Institute, the national association of the American investment company industry. The Institute's membership includes 5,664 open-end investment companies ("mutual funds"), 449 closed-end investment companies, and 11 sponsors of unit investment trusts. The Institute's mutual fund members have assets of over $2.5 trillion, accounting for approximately 95 percent of total industry assets, and have over 38 million individual shareholders. These shareholders reside in all 50 states and the District of Columbia.

I am pleased to testify on the provisions in H.R. 2131 that would redefine the roles of federal and state governments in the regulation of mutual funds. The mu-

tual fund industry has always supported strong federal regulation of our industry and a well-funded United States Securities and Exchange Commission. We continue to do so because history demonstrates that strong regulation is essential to maintaining public confidence in the mutual fund industry. We also believe there is an important role for state governments in regulating aspects of the securities market. But we are convinced that the current system of dual federal-state regulation of mutual funds is harmful to our investors, and hence to our industry.

My testimony today will describe the current regime of mutual fund regulation by state governments—a system of disparate, inconsistent and often conflicting requirements that harms investors. The minority of states that currently impose such requirements presumably do so in the honest—but mistaken—judgment that their actions are necessary to protect investors. Likewise, it should be noted that the regulatory approaches of some states *do* respond to the need for national consistency and uniformity by relying upon the SEC in matters of mutual fund disclosure and portfolio management. Unfortunately, the objectives of these states and the SEC are frustrated by idiosyncratic actions by other states—all it takes is one state to thwart uniform policies for investor protection. I will provide specific examples illustrating this problem, including: (1) substantive limitations by states on what a fund may invest in, which are inconsistent with federal requirements, and (2) requirements by states that fund prospectus disclosure already cleared by the SEC staff be rewritten, supplemented, or rearranged.

My testimony will demonstrate how the current system disserves investors by frustrating national policies designed to benefit investors (such as prospectus simplification), hindering innovations in products and services permitted under federal law, imposing needless burdens on funds and diverting resources away from areas where state action genuinely is needed to protect investors. Despite strenuous efforts by the fund industry, the SEC, and some state officials, neither the states individually nor collectively through the North American Securities Administrators Association ("NASAA") have achieved the degree of uniformity necessary to ensure efficient and effective protection of investors. As a result, a Congressional solution is needed to eliminate the bad features of the current system of dual federal-state regulation while enhancing the desirable ones.

Specifically, such a solution should delegate the regulation of mutual fund prospectuses and advertising, and the structure and operation of mutual funds (including what a fund may invest in) exclusively to the federal government. Congress should expressly reserve for states the right to receive notice filings and to collect fees, as well as jurisdiction over fraud and sales practice abuses. This division of responsibility is already reflected in the approaches taken by a substantial number of states.

Some suggest that Congressional action should be delayed pending a study. The problems inherent in the dual federal-state regulatory system over mutual funds, however, are well known and indeed have been studied *ad nauseam.* The solution is apparent, sorely needed and long overdue.

II. THE CURRENT SYSTEM OF MUTUAL FUND REGULATION

A. Federal Regulation

No segment of the securities industry is more strictly regulated at the federal level than mutual funds. Mutual funds are subject to four federal securities acts—the Securities Act of 1933, which requires the registration of fund shares, requires prospectus disclosure and strictly regulates the contents of advertising; the Securities Exchange Act of 1934 and the regulations of the National Association of Securities Dealers, Inc., which regulate distributors of mutual funds as broker-dealers; the Investment Advisers Act of 1940, which provides for the registration and regulation of investment advisers to mutual funds; and the Investment Company Act of 1940.[1]

Unlike the other federal securities laws, which are designed to protect investors primarily through *disclosure,* the Investment Company Act imposes a series of detailed, *substantive* requirements and restrictions on the structure and day-to-day operations of mutual funds. The core objectives of the Act are to: (1) ensure that investors receive adequate, accurate information about the mutual fund; (2) protect the physical integrity of the fund's assets; (3) prohibit or regulate forms of self-dealing;

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[1] In addition to the federal securities laws, almost all mutual funds qualify as "regulated investment companies" under Subchapter M of the federal Internal Revenue Code in order to avoid the imposition of double taxation on the funds and their shareholders. Subchapter M imposes a number of substantive requirements concerning asset diversification, sources of income and current distribution of income to fund shareholders.

(4) restrict unfair and unsound capital structures; and (5) ensure the fair valuation of investor purchases and redemptions.

This extensive scheme of SEC regulation at the federal level imposes a strict discipline on mutual funds to which other pooled investment vehicles generally are not subject and provides an important source of investor confidence in the integrity of the mutual fund industry. Moreover, it should be noted that these SEC-mandated investor protections apply to *all* fund shareholders and *all* mutual funds, regardless of the state in which they are incorporated or organized, where they or their advisers are located, or where fund shareholders reside.

B. State Regulation

On top of this extensive system of federal regulation, mutual funds also must comply with regulation by all states in which they are sold. In contrast to federal regulation, the manner in which the individual states regulate funds varies tremendously state by state.

The Institute has identified eighteen variants on mutual fund regulation at the state level—and the result is a crazy-quilt of inconsistent regulation. For example:

- Some states exempt all mutual funds from registering their shares for sale, most do not. Of states granting exemptions, some require funds to make a filing, others do not.
- Some states exempt only *some* funds from registration. Of these, some actively review the prospectuses of those funds that do not claim the exemption, others do not.
- Of those states that do *not* grant exemptions, some actively review mutual fund prospectuses and written advertising, others do not. Some review prospectuses, but not advertising.
- Some states impose their own restrictions on mutual fund portfolio investments, most do not.

I would draw your particular attention to the attached map that illustrates in graphic detail the different standards applied by the states. Moreover, the pattern of regulation at the state level varies not only state-by-state, but also year-by-year and, not infrequently, fund-by-fund. A state that has previously commented on fund prospectuses may elect to defer to the SEC's review of these documents. At the same time, another state that had *not* previously conducted its own review may suddenly elect to issue comments. These shifts rarely are preceded by changes in states' rules and often simply reflect the approaches taken by different state personnel. Moreover, two different mutual funds, even within the same fund complex, can be treated very differently by the same state at the very same time.

The mutual fund industry today is quintessentially national in character. Virtually all funds, in order to serve their investors, offer their shares on a nationwide basis. The reasons for this include, among other things, the increasing utilization of nationally available telecommunications and computer networks to communicate with investors; extensive coverage of mutual funds by the national media, which generates inquiries from investors in every state; and the increasingly mobile nature of American investors who may move their place of work and residence from one state to another many times during their lives.

Supreme Court Justice Louis Brandeis, in discussing the proper balance of powers and limitations between state and federal regulation, stated:

> It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory, and try novel social and economic experiments without risk to the rest of the country.[2]

Applying the Brandeis test, the experiment of permitting states to regulate mutual fund portfolios, prospectus disclosure and advertising alongside the federal government clearly has failed. Despite manifest problems and costs to investors, states exercise their regulatory authority in a manner inconsistent both with federal law and with each other. Moreover, it is virtually impossible to confine the impact of a state's activities to its citizens. Portfolio limitations imposed on a fund by a single state affect *all* the fund's shareholders nationwide. Similarly, one state's unique prospectus disclosure requirements often affect the disclosure received by *all* shareholders everywhere. Continuing the "experiment" is, in Justice Brandeis' terms, fraught with "risk to the rest of the country."

In the section that follows, we provide detailed examples of how certain states regulate mutual funds in two areas—first, the unique limitations they place on what mutual funds may invest in; and second, the disclosure requirements they impose on fund prospectuses and other shareholder communications. These examples are

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[2] *New State Ice Company v. Liebmann,* 285 U.S. 262, 279 (1932) (Brandeis, J., dissenting).

based on reports by Institute members across the country of the real-life consequences of the dual regulatory system as it exists today. I should emphasize that these examples—troubling though they are—are *not* an indication of any ill-will. In my own experience, individual state regulators genuinely intend to serve the interests of the investing public. The result, however, of their activities within the current dual federal-state system in which they operate is often harmful to investors and antithetical to this purpose.

III. STATE REGULATION OF MUTUAL FUND PORTFOLIOS AND DISCLOSURE DOCUMENTS

A. Portfolio Limitations

As noted earlier, the Investment Company Act, together with the rules and regulations promulgated by the SEC under the Act, imposes detailed *substantive* standards on the operations of mutual funds. Many of these standards are specifically directed to what a fund may invest in. For example, the SEC limits a fund's investments in illiquid securities. Certain types of investment techniques—such as engaging in short sales and writing options—are subject to various restrictions. The manner in which a fund's investments are valued is strictly regulated by the SEC. Money market funds are subject to extensive limitations on their portfolios pursuant to Rule 2a-7. In addition, fund investments in certain instruments are limited by the rules of Commodity Futures Trading Commission.

Even in the face of the SEC's national standards, widely-recognized for their effectiveness, states can and do impose unique restrictions on the management of a fund's portfolio—*the* essential service our industry provides to shareholders. Funds are offered on a nationwide basis and portfolios must be managed identically for all of a fund's investors, without regard to the state where they live. Thus, the portfolio restrictions imposed by one state will dictate how the portfolio will be managed for investors in *all* states. Accordingly, so long as even one state insists upon imposing a condition that will restrict the ability of a portfolio manager to invest his or her fund in a manner consistent with federal law, *investors in all states will be adversely affected.*

At least eight states have express provisions that impose on funds certain substantive portfolio limitations that are inconsistent with federal law.[3] Although each of these states has been urged repeatedly by mutual funds and NASAA to conform their provisions to federal law, to date, only one—Wisconsin—has taken affirmative steps to eliminate this inconsistency.[4]

Some of these limitations restrict a fund's ability to invest in various assets, including commodities, restricted securities, oil, gas or mineral programs, options and warrants, interests in real estate, and other securities. For instance, Arkansas, California, South Dakota and Texas each limit a fund's investments in options and warrants—though no two of these states do so in the same way. In Texas, a fund may not invest more than 5% of its assets in warrants, and no more than 2% of this 5% may be invested in warrants not listed on the New York or American Stock Exchanges. In California, funds may only invest in options that are issued by the Options Clearing Corporation, which means that a fund may not invest in over-the-counter options or in options listed on foreign exchanges. In Arkansas, a fund may invest up to 5% of its assets in options without further restriction. In South Dakota, a mutual fund may not invest more than 5% in options, other than hedging positions or positions that are covered by cash or securities.[5]

Complying with these various state provisions is not easy or inexpensive. It often requires utilizing complex specialized computer tests to ensure that each investment made by the fund conforms to all applicable unique state limits. More importantly, a state's adherence to its unique limitations can frustrate national initiatives of the SEC. For example, in 1992, the SEC issued a policy statement providing that not all restricted securities held by a fund would be treated as *per se* illiquid.[6] In the

[3] The eight states are Arkansas, California , Missouri, Ohio, South Dakota, Texas, Washington and Wisconsin.

[4] Actions taken by the Wisconsin Commissioner of Securities over the past year should result in complete uniformity between Wisconsin law and federal law by January, 1996.

[5] Not all limitations on fund portfolio investments are expressly provided for under state law. It is not uncommon for examiners in those states that actively peview prospectuses to request, through the comment process, changes in a fund's investment program.

[6] In particular, the SEC's policy, which was intended to facilitate institutional transactions, permitted mutual funds to determine which of certain restricted securities (*i.e.*, those that meet the conditions of Rule 144A inder the Securities Act of 1933) held in their portfolios were illiquid and, thus, subject to the SEC's 15% lined on investments in illiquid securities. Prior to this change, all Rule 144A securities were considered illiquid.

three years since the SEC issued this change in policy, every state but one has followed suit. The one exception is Ohio, which has remained wedded to an approach first adopted in 1971. As a result, funds that want to be sold in Ohio (which has the *sixth* largest concentration of mutual fund shareholders after New York, Florida, California, Texas and Pennsylvania) must either conform to Ohio's unique restriction, thereby in effect overriding the SEC's policy, or add a sticker to their prospectus directed "To Ohio Residents" and informing them of Ohio's unique limitation. While the sticker is explicitly directed to Ohio residents, using a sticker for residents of one state is costly and administratively difficult for funds sold nationwide.

B. Disclosure Requirements

Under the federal securities laws, the key disclosure document, which must be provided to all fund investors, is the prospectus. Pursuant to its regulatory authority, the SEC dictates, in Form N-1A, the type of information that must be included in a fund's prospectus. For example, Form N-1A requires that the prospectus include all important information about a fund—including its investment objectives and policies, expenses, financial information, management, and how to purchase and redeem shares. It also specifies the order of presentation of certain information and requires certain matters to be included on the cover page. Form N-1A recognizes the importance of presenting this information in a manner that is useful to investors:

> Because investors who rely on the prospectus may not be sophisticated in legal or financial matters, care should be taken that the information in the prospectus is set forth in a clear, concise, and understandable manner. Extensive use of technical or legal terminology or complex language and the inclusion of excessive detail may make the prospectus difficult for many investors to understand and may, therefore, detract from its usefulness.[7]

Yet, in spite of these extensive federal standards, approximately a dozen states *routinely* impose on fund prospectuses their own unique disclosure requirements that differ markedly from those under Form N-1A.[8] As a result, prospectus information must be rewritten, supplemented with additional information that an individual state deems important, rearranged, or relabeled irrespective of the fact that the disclosure has been thoroughly reviewed by the SEC staff. Moreover, the effect of these requirements often is to frustrate the SEC's direction that information included in the prospectus be presented "in a clear, concise, and understandable manner."

Mutual fund advertising also is subject to detailed regulation under various SEC rules. In addition, most funds are required to file their advertising with the NASD, which reviews them for compliance with federal law, as well as with its own Rules of Fair Practice. (Funds that are not affiliated with members of the NASD do not file their advertising with the NASD but with the SEC.) In recognition of this extensive layer of federal regulation, most states do not require funds to file their advertising at the state level. However, six states—California, Indiana, Massachusetts, Texas, Vermont and West Virginia[9]—require funds to file their advertising and one of those states—Vermont—actively reviews mutual fund advertising.

1. Requiring that Prospectus Disclosure Be Rearranged

Form N-1A requires that mutual funds organize the information in their prospectuses in a way that makes it easy for investors to understand important information about the fund. For example, the SEC requires that the cover page be immediately followed by the fee table, which must then be followed by condensed financial information. Notwithstanding the SEC's requirements to ensure the prominence of certain information, it is common for state examiners to insist that particular information in the prospectus be reordered or moved to the "front" (and often times to the cover page) of the prospectus. Placing too much information on the cover page, however, can confuse investors or give undue prominence to relatively less significant information.

Reported examples of states arbitrarily "rearranging" prospectus disclosure to suit their own preferences, after the SEC staff has cleared the prospectus, include the following:

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[7] SEC Form N-1A, General Instruction G.

[8] Based on the recent experiences of our members, the twelve states whose examiners most frequently issue their own comments on prospectuses are Arizona, Arkansas, California, Maryland, Massachusetts, Minnesota, Missouri, New Jersey, Ohio, South Dakota, Texas and Vermont. (New Jersey and South Dakota both exempt some funds from registration, but often comment on prospectuses of funds that do not claim the exemption).

[9] West Virginia only requires funds that do not claim the "blue chip" exemption to file advertising.

- One state required a fund to move the "Investment Practices", "Investment Restrictions" and "Risk Factors" sections of the prospectus to the front of the prospectus.
- A second state required that a section discussing the fund's investment policies be set forth prior to a section on management of the fund.[10]
- A third state required that a fund move disclosure regarding the speculative nature of some securities from page 17 of the prospectus to page 8.
- A fourth state required that discussion of a fund's investments in repurchase agreements and foreign securities be written to appear within a section labeled "How the Fund Invests" rather in the section "Restrictions on the Fund's Investments."

Some state comments concern the allocation of disclosure between a fund's prospectus and its statement of additional information (or "SAI"), which is a document that contains more detailed information and that is available to investors upon request. The SEC developed the SAI in 1983 in order to ensure that information that would not be relevant to most retail investors did not needlessly encumber the prospectuses they received.[11] Nevertheless, it is not uncommon for states to require funds to move information from the SAI to the prospectus. For some period, one state even required all funds to deliver the SAI to all investors in the state in direct contravention of SEC requirements.

2. Requiring that Prospectus Disclosure be Rewritten or Relabeled

Although the format and information that must be included in a fund's prospectus is expressly provided by Form N-1A, states often require that prospectus information be rewritten or relabeled. For example, one state recently required a fund to amend its fee table to add parenthetical information that was already included elsewhere in the table as well as in footnotes to the table. Other reported examples of state comments requiring that fund disclosure be rewritten or relabeled include the following:

- One state requires funds that invest in debt securities rated BBB by Standard & Poor's to rewrite their prospectuses to label such securities "speculative," notwithstanding that BBB rated securities are considered to be investment grade.
- Another state has asked a fund to replace or modify "phrases describing 'reasonable' and 'excessive' risk with words that are easily definable and understood by the investor."

3. Requiring Additional Prospectus Disclosure

States often require that more disclosure be added to a mutual fund's prospectus or SAI. For instance, a fund that intended to invest in real estate investment trusts ("REITs") was told by a state that if these REITs included any long term health care properties, such as nursing homes, retirement homes and assisted living homes, the prospectus must include disclosure that such investments may be impacted by any new federal regulations concerning health care. Also, in February of this year, a state required a fund that was investing half of its portfolio in zero coupon bonds and half in actively managed securities to add boldfaced disclosure to its prospectus cover page informing investors that they could achieve the same investment results by dividing their investment dollars in half and putting half in zero coupon bonds and half in an actively traded fund. It also required another fund to include disclosure that dealers selling the fund must be registered in the state in which such sale is to be made.

Comments such as these make prospectuses longer and more complicated. They result in disclosure of information that is either confusing or immaterial to investors. They frustrate the prospectus simplification efforts of the SEC and the fund industry.

C. The Ever-Changing Nature of State Requirements

The restrictions imposed on what funds invest in, as well as requirements governing prospectus disclosure, not only vary among the individual states, but also frequently change over time. A modern mutual fund complex, often consisting of scores

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[10] This state also has required that sections covering risk factors be included near the front of the prospectus. It gives inconsistent comments, however, on whether this must be within the first five pages or the first ten pages.

[11] In the adopting release, the SEC stated that the information included in the SAI "does not appear to be of fundamental importance to most investors" and is intended to meet the needs of investors such as "institutional investors" and "financial analysts." *See* Investment Company Release No. 12927 (Jan. 7, 1983).

if not hundreds of mutual funds, thus, can never be sure which standards will be applied to any of its funds by a given state at a particular point in time.

For instance, Ohio has a rule stating that a fund may not invest more than 15% of its assets in the securities "of unseasoned issuers or securities of issuers that are restricted as to disposition." In 1993, a fund wrote to the Ohio Division of Securities to ask whether this 15% limitation was cumulative or whether a fund could invest up to 15% in securities of unseasoned issuers *and* up to 15% in restricted securities. The fund received a written response from the Division stating that the "Division does not interpret the 15% limitation to be cumulative." In renewing its registration statement for 1995, however, the fund received a letter from the Division taking the opposite position and asking that the fund demonstrate its compliance with this *cumulative* limitation.

In another example, this year one state started requiring funds to include additional disclosure concerning investments in derivatives without providing any guidance as to what the securities department considered to be a derivative and what type of disclosure would accommodate its concerns. The Institute worked with the department to develop such guidance in the form of written guidelines. Within a week of the department's approval of such guidelines and their being disseminated to Institute members, the department's staff began deviating from them. When asked about this, the department responded that the guidelines were not binding and that it could exercise its own discretion about when the guidelines should be applied.

IV. THE HARMFUL CONSEQUENCES TO INVESTORS

This crazy-quilt of conflicting, duplicative and inconsistent regulatory requirements harms investors in many important ways. First, it frustrates the implementation of national regulatory policies that are clearly beneficial to investors. Second, it retards innovations in products and services that are permitted under federal law and are beneficial to investors. Third, it imposes needless burdens on mutual funds. Fourth, and not least importantly, it diverts scarce state governmental resources away from regulatory priorities, where state action *is* required to protect investors. Each of these is discussed briefly below.

A. Frustrating National Regulatory Policies

The crazy-quilt system frustrates national policies designed to benefit investors. This is best illustrated in the area of shareholder communications. The SEC has launched several initiatives designed to enhance the readability of mutual fund prospectuses. In an October 1994 speech to the National Press Club, SEC Chairman Arthur Levitt discussed initiatives of the SEC to ensure that prospectuses are more readily understandable to investors:

> If you didn't before, you know now that prospectuses can be tough to read. The prose trips off the tongue like peanut butter.... I wish I could say that the SEC had nothing to do with the status quo, but I can't. We've contributed to the situation, albeit with the best intentions—and so have our fellow regulators.... The law of unintended results has come into play: Our passion for full disclosure has created fact-bloated reports, and prospectuses that are more redundant than revealing.... For our part, I've asked the staff to re-evaluate the process by which it comments on prospectuses. I've emphasized the need to limit the number and nature of the comments we give.... [I]n commenting on fund registration statements sent to us for review, we're going to feel free to talk about the clarity of language used.... We want a higher standard of clarity.[12]

The Investment Company Institute and its members strongly subscribe to the principles set out by Chairman Levitt. We have undertaken extensive efforts to assure that *all* our communications with shareholders are clear, concise and accessible. The examples of state intervention in the disclosure process, set forth in Section III.B. above, amply demonstrate the difficulty of achieving this objective within the current regulatory system, in which disclosure issues are the province of numerous contending government authorities, each with its own preferences and inclinations. The problem here is not one of resources; the SEC *has* sufficient resources to implement effective disclosure policies in the interests of investors. What it lacks is sufficient authority. Until and unless the SEC is put squarely and exclusively in

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[12] Remarks by Arthur Levitt, SEC Chairman, "Taking the Mystery Out of the Marketplace: The SEC's Consumer Education Campaign," *National Press Club*, Washington, D.C. (Oct. 13, 1994) (emphasis added).

charge of mutual fund disclosure, fund prospectuses will remain needlessly long, complex and difficult for the average investor to decipher.

B. Retarding Product and Service Innovation

It is widely recognized that mutual funds have been leaders in responding to changing investor needs during the past several decades by introducing new products, by improving shareholder services and by providing many new services.[13] In not a few cases, however, state regulation has made product innovations approved by the SEC far harder to deliver to shareholders.

One example concerns the so-called "master/feeder" structure, an organizational framework that many funds have adopted in recent years as a means to reduce shareholder expenses and achieve economies in fund management while facilitating distribution of their shares. The master/feeder structure was accepted by the SEC after rigorous examination and after it had fashioned a system of regulation and disclosure that it believed would fully protect shareholders. Several state securities regulators, however, refused to accept the SEC's judgment and sought to impose their own idiosyncratic requirements. In an effort to obtain uniformity among the states, NASAA adopted its own guidelines on master-feeder funds. These NASAA Guidelines, according to the counsel to many such funds, require the addition of approximately one to two *pages* of additional prospectus disclosure, *beyond that required by the SEC.* Even worse, despite the promulgation of the NASAA Guidelines, a number of states require still more disclosure. For funds that have chosen to adopt the master/feeder structure, state regulation has produced delay, operational difficulties and needless legal and compliance costs.

In addition to concerns about the way in which state regulation impedes innovation in fund products, there is serious and growing concern in the mutual fund industry about the impediments state securities regulators will erect to the use of electronic communications. Mutual funds now use sophisticated electronic and telecommunication systems to offer their funds nationwide and to provide enhanced services to shareholders. Many fund groups have established sites on the Internet or on one of the major on-line services. Moreover, a preliminary survey by the Institute, based on a sample of approximately 1500 randomly selected shareholders, showed that over 50% owned personal computers (as opposed to one-third of the general population), and approximately one-half of them subscribed to an on-line service. To encourage this important, fast-developing trend, the SEC recently issued a release endorsing the use of the electronic media as a means for dissemination of information to investors and setting forth national standards for such communications.[14] We applaud the efforts of Chairman Levitt and Commissioner Steven Wallman to encourage the use of such technologies by mutual funds. The problems that state regulation pose for mutual funds in a "paper environment," however, are sure to pale before those that will arise in cyberspace. The losers will be fund shareholders. A national regulatory system under the SEC is imperative.

C. Imposing Needless Compliance Burdens on Funds

The crazy-quilt of state regulation is costly and burdensome for mutual funds that must comply with the diverse state requirements. Mutual funds must commit substantial resources and personnel to manage the requirements of the various states. The recent experience of one fund, related to us by its counsel, is illustrative. This fund received comments from approximately sixteen state securities administrators on its initial registration. After the fund responded to these comments, several state examiners made further comments. In total, the fund was forced to respond to 36 comment letters addressing 102 comments or requests for documents from various state regulators. This was, of course, in addition to the comments received by the fund from the SEC staff.

This example is not unique. It illustrates the reason why many fund groups must employ a special staff dedicated to dealing with the demands imposed by state regulators, and why all funds are forced to bear significant additional legal and compliance costs as a result of inconsistent state regulation.

D. Diverting Resources From Areas Where State Action is Needed to Protect Investors

Finally, the crazy-quilt of state regulation results in the inefficient use of states' resources. Indeed, a recent annual survey by a NASAA Committee identified only 350 complaints nationwide relating to mutual funds. None of these complaints in-

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[13] These services include, for example, national toll-free (800) telephone numbers; 24-hour telephone access; consolidated account statements; shareholder newsletters; shareholder cost basis information; and investor information provided through the Internet and on-line computer services.

[14] Investment Company Release Nos. 21399 and 21400 (Oct. 6, 1995).

volved fund prospectus disclosure or advertising,[15] but instead concerned primarily the manner in which fund shares were sold. Former NASAA President John Perkins said in a recent interview that "states don't have large enough staffs to investigate all complaints."[16] One reason may be that many states unnecessarily devote resources to duplicating federal regulation of mutual funds, rather than directing their resources to other targets where state action is needed to protect investors.

V. THE NEED FOR A CONGRESSIONAL RESOLUTION

The introduction of H.R. 2131 provides an excellent opportunity to remedy the worst aspects of the current dual system of federal-state regulation of mutual funds, while preserving the best features. The "experiment" of idiosyncratic state regulation has been a failure and should be discarded.

The individual states, through experimentation, long have had the opportunity to come up with a practical approach, and they have not done so. They also have had the opportunity, through concerted action, to rationalize the current system. Years of effort by the mutual fund industry and the SEC to work with the states individually and with NASAA collectively to obtain a uniform system of regulation have been unavailing.

In fact, in recent years, the clear trend among NASAA's leadership has been to actively oppose the cause of uniformity. In 1985, the National Conference of Commissioners on Uniform State Laws adopted a model act for state securities regulation. The model contained an exemption from state regulation for mutual funds with experienced investment advisers, but left undisturbed the states' authority to require filings, collect fees and enforce sales practices. Since 1985, twelve states have adopted some form of such exemption. But, in 1991, the NASAA Board approved a resolution opposing the Uniform Securities Act exemption and "strongly encourag[ing]" those states that had already adopted exemptions to abandon them and hence resume active regulation of mutual funds. More recently, NASAA and certain state regulators cite their efforts to develop an electronic filing system for registrations and renewals known as the Securities Registration Depository ("SRD") as evidence that they have been working towards a more uniform national marketplace. In fact, the opposite is true. The SRD intentionally has been designed by NASAA not to promote uniformity, but to accommodate—and hence perpetuate—conflicting and inconsistent state filing requirements.

Given that these attempts at the state level to establish uniformity have failed, only Congress can remedy the situation. A national problem requires a national solution. The interests of fund shareholders and the nature of the investment company marketplace command the creation of a new federal/state partnership.

Specifically, the regulation of fund prospectuses and advertising and the structure and operations of investment companies should be delegated exclusively to the federal government.[17] States could require notice filings, receive fees and concentrate on fraud, sales practice abuses and investor education. Such a reallocation of federal and state responsibilities would be of immense benefit to investors throughout the nation. In fact, many states have already recognized the benefits of this regulatory scheme. In those states, mutual funds generally make notice filings, pay fees and are subject to anti-fraud jurisdiction, but their prospectuses and advertisements are not subject to state review and the states do not impose substantive limits on fund operations. There is no evidence that investors in these states are at any greater risk—to the contrary, investors *benefit* because their state securities regulators apply their resources to other areas where state action is required for their protection.

Some suggest that problems with the current system should be reviewed and studied by a commission, and presumably that we should await its judgments before Congress acts. State mutual fund regulation, however, has been a matter of study and debate for years, including by NASAA. In September 1983, for example, joint hearings were held by NASAA and the SEC on the need for greater uniformity in federal and state securities laws and regulations, including those with respect to

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[15] NASAA Investment Companies Sales Practices Committee, *Annual Survey of Investor Complaints Involving Investment Company Products* (Sept. 15, 1994).

[16] Jane Bryant Quinn, *Broker's File Can Disclose Trouble, For Now,* Cincinnati Enquirer (Oct. 1, 1995).

[17] It is interesting to note that the benefits of a national marketplace have been recognized in other aeas, where it has been determined that exclusive federal regulation is appropriate. For example, the Commodity Exchange Act vests the CFTC with exclusive jurisdiction over commodities transactions, but preserves the capacity of state regulators to redress fraudulent activity perpetrated in their jurisdictions. Commodity Exchange Act §§ 2(a)(1) & 6d, 7 U.S.C. §§ 2 & 13a-2(7).

mutual funds. After the hearings, NASAA appointed an Investment Companies Committee to study the issue further and make recommendations. In the Committee's Final Report, the Committee acknowledged that the problems resulting from lack of uniformity could be rectified without compromising investor protection, and found that uniformity would permit states to "allocate their staff's time and resources more productively and efficiently." The Committee recommended that states adopt a more uniform approach to mutual fund regulation and eliminate duplicative or inappropriate substantive provisions.[18] Although the recommendations were endorsed by NASAA in September 1984, this did *not* produce the system of uniform regulation that even NASAA found to be desirable. Eleven years later, the crazy-quilt is more crazy and harmful to investors than ever.

In short, the problems with the current dual system of federal-state regulation of mutual funds are extensively documented. Yet another study would add little to the wealth of information already available, and likely would serve only to delay action that is long overdue. The problems that I have described are so inherent and ingrained in the current system of regulation that they can only be solved by Congress—and they should be solved now.

Mr. FIELDS. Thank you, Mr. Fink.

Mr. Charles Shufeldt, representing the American Bankers Association.

STATEMENT OF R. CHARLES SHUFELDT

Mr. SHUFELDT. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, I am Charles Shufeldt, President and CEO of SunTrust Capital Markets located in Atlanta, Georgia. SunTrust Capital Markets is a wholly owned subsidiary of SunTrust Banks, a bank holding company operating banks in Georgia, Florida, Tennessee and Alabama.

I appear here today on behalf of the American Bankers Association and the ABA Securities Association, ABASA. ABASA, on whose board I sit, was formed in 1995 to develop policy and to provide representation for banks underwriting and dealing in securities, proprietary mutual funds and derivatives. ABASA's members are institutions with Section 20 affiliates and regional banks with extensive distribution channels for securities and mutual funds and insurance products.

Mr. Chairman, I appreciate the opportunity to be here and present the views of the banking industry on H.R. 2131, the Capital Markets Deregulation and Liberalization Act of 1995. And although I am here to discuss the views of the banking industry, I must note that H.R. 2131 is also important to my own banking organization in a number of areas. Let me elaborate.

SunTrust is an issuer of securities, with a market capitalization of approximately $7.7 billion, representing 114 million shares outstanding.

SunTrust is also an investor in the market. Our combined holding company securities portfolios had a market value of $9.5 billion at the end of the second quarter of 1995. SunTrust also invests in the market on behalf of others, managing over $42 billion in assets through our various trust departments and our registered investment advisor.

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[18] Predictably, the Committee's recommendations stopped short of recommending complete uniformity: "The Committee does not wish to imply that it is in any way inappropriate for a [state] to apply substantive requirements. However, the Committee believes that it is proper to review this area to determine if the requirements are currently useful and appropriate."

Of that $42 billion in assets, $5 billion is in mutual fund assets, and I would stress the $5 billion, unlike our written testimony which says $5.

SunTrust also serves as bondholder trustee or fiscal paying agent for over 400 issues, representing $30 billion in principal amount outstanding.

And finally, SunTrust has two registered broker dealers, SunTrust Capital Markets, our section 20 holding company underwriting subsidiary, and SunTrust Securities, our retail broker-dealer subsidiary.

As you can see, Mr. Chairman, my organization, much like the rest of the banking industry, has a very real interest in many of the provisions contained in H.R. 2131. The bill continues efforts to reduce regulatory burdens and costs begun last year by the Congress when it enacted the Riegle Community Development and Regulatory Improvement Act of 1994.

While that act focused on reducing unnecessary and duplicative regulatory burdens associated with the business of banking, H.R. 2131 focuses on reducing the many significant burdens associated with raising capital in our markets. Lowering the cost of capital formation benefits the economy, business, banking, or otherwise, as well as investors and consumers. Consequently, ABASA strongly supports in principle this most important piece of legislation.

One of the most important features of H.R. 2131 is the creation of a unified system of securities regulation and the elimination of duplicative and burdensome State regulation. At the same time, investor protection needs are satisfied and important State interests in regulating various aspects of the securities industry are preserved.

Specifically, section 3 of H.R. 2131 would provide that corporations seeking access to the capital markets need only register their securities with the Securities and Exchange Commission.

Second, securities professionals seeking to be registered, licensed, and qualified will be assured that they need only do so according to the dictates of the Federal securities laws.

Third, and finally, the bill provides that the Commission will have exclusive jurisdiction with respect to registered investment companies and investment advisors.

ABASA supports the proposed unified system of securities regulation. The various components of the proposed unified system do not sacrifice investor protections or their interests at the expense of reducing regulatory burdens. Registration would generally still be required, albeit only once.

ABASA, last, supports the notion that broker-dealers should not be liable for the investment decisions of an institutional investor. Institutional investors are capable of making their own investment decisions independent of any broker-dealer recommendations and thus do not need the same protections afforded by the securities laws to individual retail investors.

ABASA does not support repeal of the Williams Act or the Trust Indenture Act. In large part our position is predicated on the fact that our markets are perceived worldwide to be the most fair, orderly, and open of all markets. Repealing important investor protection provisions such as the Williams Act and the TIA could have

the unintended consequences of altering investor perception and driving investors away.

We do, however, believe that amendments can be made to the Williams Act provisions to avoid duplicative reporting requirements. Specifically, we believe that much can be done to eliminate overlap in the reporting required in the schedule 13(g) and 13(f) reports.

We would offer to assist committee staff and other appropriate parties in developing a new and improved reporting scheme if in fact evidence indicates that one is necessary that would streamline and reduce current regulatory duplication.

Mr. Chairman, you are to be commended for your leadership in spearheading this drive to modernize and revise our Nation's securities laws and reduce unnecessary and burdensome securities regulation. ABASA is very supportive of these efforts and pledges to work with you, the regulators, and other industry groups to take whatever steps are necessary to accomplish these important goals.

I thank you for the opportunity to appear here today and would be happy to answer any questions.

[The prepared statement of R. Charles Shufeldt follows:]

Prepared Statement of R. Charles Shufeldt on Behalf of the American Bankers Association and the ABA Securities Association

Mr. Chairman and members of the Subcommittee, I am Charles Shufeldt, President and CEO of SunTrust Capital Markets, Inc. ("STCM"), located in Atlanta, Georgia. STCM is a wholly-owned subsidiary of SunTrust Banks Inc. ("SunTrust"), a bank holding company operating banks in Georgia, Florida, Tennessee, and Alabama. I appear here today on behalf of the American Bankers Association ("ABA") and the ABA Securities Association ("ABASA"). ABASA, on whose Board I sit, was formed in 1995 to develop policy and provide representation for banks underwriting and dealing in securities, proprietary mutual funds and derivatives. ABASA's members are institutions with Section 20 affiliates and regional banks with extensive distribution channels for securities, mutual funds and insurance products. The ABA Securities Association is a separately chartered trade association of the ABA, the only national trade and professional association serving the entire banking community.

Mr. Chairman, I truly appreciate the opportunity to be here and present the views of the banking industry on H.R. 2131, The Capital Markets Deregulation and Liberalization Act of 1995. And although I am here to discuss the views of the banking industry, I must note that H.R. 2131 also is important to my own banking organization in a number of areas. Let me explain.

SunTrust, a publicly traded corporation with approximately $7.7 billion in market capitalization, representing 114 million shares outstanding, is an issuer of securities. In addition, SunTrust frequently accesses the capital markets with securitized assets and other holding company debt instruments.

SunTrust is also an investor in the market. Our combined holding company securities portfolio was in excess of $9.5 billion for the second quarter of 1995. SunTrust also invests in the market on behalf of others, managing over $42 billion in assets through our various trust departments and our registered investment adviser. Of that $42 billion in assets, $5 represents mutual fund assets.

SunTrust also serves as bondholder trustee or fiscal paying agent for over 400 issues, representing $30 billion principal amount outstanding. Finally, SunTrust has 2 registered broker-dealers. STCM of which I am President, is a Section 20 bank holding company subsidiary, organized in 1994 to serve our customers' underwriting needs. We are approved to underwrite commercial paper, municipal revenue bonds, and certain asset-backed securities, in addition to bank eligible securities. SunTrust securities, for which I also serve as president, is a registered broker-dealer subsidiary of our lead holding company bank and is structured to handle our retail brokerage business.

As you can see, Mr. Chairman, my organization, much like the rest of the banking industry, has a very real interest in many of the provisions contained in H.R. 2131.

Let me also say on behalf of ABASA that you are to be commended for your leadership in spearheading this drive to modernize and revise our nation's securities laws and reduce unnecessary and burdensome securities regulation. Many of the provisions of H.R. 2131, we believe, will accomplish these very worthy goals.

DISCUSSION

Reducing regulatory burden is, as you and the other Committee members well know, a super priority of the banking industry. The cost of regulation is not just a minor nuisance for bankers—it has a significant impact on bank customers and local economies. A survey of ABA members found that banks alone, not their holding companies or non-bank affiliates, spend, on average, about 10 percent of their operating costs on compliance. For 1994, this translated into more that $14 billion. I would submit that $14 billion is a lot of money that could be put to better use in our local communities. The bottom line is that compliance costs are a significant drain on bank resources. And the results are more expensive bank products and lower economic growth—in many cases with little or no consumer benefit. This same can be said with respect to duplicative and unnecessary securities compliance costs.

A critical first step in reducing regulatory costs was taken last year by the Congress when it enacted the Riegle Community Development and Regulatory Improvement Act of 1994. That legislation has made a significant dent in reducing unnecessary and duplicative regulatory burdens for banking organizations, thereby providing benefits for consumers. But as you know, Mr. Chairman, more needs to be done.

I am pleased to note that more is being done. H.R. 2131 represents a significant step toward reducing many of the burdens associated with raising capital in our markets. Lowering the cost of capital formation benefits business, banking or otherwise, investors and, and, most importantly, consumers. ABASA strongly supports, in principle, this most important piece of legislation and would offer the following comments for the Committee's consideration.

NATIONAL UNIFIED SYSTEM OF SECURITIES REGULATION

One of the most important features of H.R. 2131 is the creation of a unified system of securities regulation and the elimination of duplicative and burdensome state regulation. At the same time, investor protection needs are satisfied and important state interests in regulating various aspects of the securities industry are preserved.

Specifically, Section 3 of H.R. 2131 would provide that corporations seeking access to the capital markets need only register their securities with the Securities and Exchange Commission ("Commission"). Second, securities professionals seeking to be registered, licensed and qualified will be assured that they need only do so according to the dictates of the federal securities laws. Third and finally, the bill provides that the Commission will have exclusive jurisdiction with respect to registered investment companies.

A. Securities Offerings

ABASA supports that aspect of H. R. 2131 which would exempt securities from the various state registration requirements if they are registered under the Securities Act of 1933 or, alternatively, are exempt from registration under Section 3(a) of the Securities Act. This provision will allow publicly traded corporations to register their securities under one law, the Securities Act. No longer will corporations that wish to offer consumers the ability to invest in their securities be required to expend both time and resources to register and qualify their securities under the laws of the fifty-two local jurisdictions.

While members of this panel can explain better than I how this provision benefits all of corporate America, I would note that this provision also provides great benefits to the banking industry. As this Committee is aware, rapid consolidation is occurring in the banking industry. Bank mergers are not limited to large banking organizations seeking to enter new geographic markets. Smaller banking organizations seeking to remain competitive in their own market area are also searching for merger partners.

A merger can be accomplished through a cash transaction, an exchange of stock, or both. Eliminating some of the costs associated with qualifying these exchanges under state law will allow these transactions to be more efficiently priced to the benefit of both companies involved and their securityholders.

Moreover, as a general matter, more efficiently priced securities will make securities more attractive to a wider investor audience. Wider investor demand allows corporations to raise needed capital more easily and more efficiently. These benefits are eventually translated into better priced products for American consumers and better and more secure jobs for American workers. For example, if asset-backed securities

are more efficiently priced, demand for these securities will increase and banks will be encouraged to sell their loan assets. The more bank assets are securitized, the more money is available in local communities through local banks for lending to consumers and others.

H.R. 2131 also preserves state jurisdiction over securities offerings in several important respects. First, states could impose separate registration requirements if the securities sought to be registered were part of a blank check offering, were to be offered only in that state, or were exempt under some provision other than Section 3(a) of the Securities Act and the Commission determined that the public interest and protection of investors would be better served by allowing state securities registration.

Secondly, H.R. 2131 would still permit states to require, under certain circumstances, duplicate filing of certain documents filed with the Commission. Moreover, nothing in H.R. 2131 would prohibit states from levying fees for filing these documents. Section 3 also makes clear that states retain concurrent jurisdiction with the Commission over antifraud violations of the Securities Act. Finally, nothing in H.R. 2131 would preclude states from exercising their traditional authority over matters pertaining to corporate governance.

While it would be far more preferable that any fees levied by state law for filing corporate disclosure documents with the state be eliminated, we do recognize the need for state securities officers to fund their enforcement and other efforts. In these times of sever fiscal constraint, we acknowledge that it is probably more palatable that these funding needs be achieved through user fees rather than through taxes. Consequently, and on balance, we believe, Mr. Chairman, that with respect to securities offerings, H.R. 2131 strikes the right balance between state and federal interests.

B. Registered Broker-dealers

In addition to eliminating duplication and burden associated with going to market with a securities offering, H.R. 2131 would eliminate duplicative regulation associated with licensing securities professionals. I am very pleased to report that ABASA also supports that provision of H.R. 2131 that would preempt state laws requiring broker-dealers, issuers and certain other associated persons to register or qualify under state law.

In addition, H.R. 2131 would prohibit states from imposing capital, financial reporting or recordkeeping requirements on securities professionals that differ from those required by the Commission. Eliminating time-consuming registration requirements and the potential for conflicting state and federal rules on capital, financial reporting and recordkeeping will certainly reduce significantly regulatory burdens for bank broker-dealers.

More importantly, investor protection interests would not be sacrificed at the expense of reducing regulatory burdens. First, states will still be able to register, license and qualify broker-dealers as long as they do so through the central registration depository ("CRD") system operated by the National Association of Securities Dealers ("NASD") and the state's registration requirements comport with those of the Commission.[1] In addition, H.R. 2131 would provide a savings clause for any state regulation that the Commission determined to be in the public interest, necessary for the protection of investors or the maintenance of fair and orderly markets. In this way, important public interests served by state regulation can be preserved upon an appropriate showing.

For many of these same reasons, ABASA would support the approach set out in Section 12 of the bill that would require that the Commission designate one self-regulatory organization ("SRO") per broker-dealer firm as the examining authority. In this way, registered broker-dealers will be able to avoid duplicative and overlapping examinations from the various SROs. Moreover, flexibility is built into the approach by allowing both broker-dealers to request and, the Commission to grant, changes in designated examining authority.

Some of our members are affiliated with brokerage firms that are members of the various exchanges as well as the NASD. It is not uncommon for these bank-affiliated brokerage firms to be separately but, consecutively, examined or inspected by

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[1] We note that H.R. 2131 would specifically permit states to charge broker-dealer licensing fees. Presumably these fees would be used to fund the activities of the state securities authorities.

their SROs, as well as their federal and state banking authorities.[2] Anything that will reduce the constant need for bank brokerage staff to devote time to overlapping regulatory inspections, as opposed to serving our clients' needs, would be most welcome.

C. Investment Companies and Investment Advisers

The third component of the proposed unified system of regulation would preempt state regulation, without limitation, as it applies to investment companies and investment advisers, registered under the Investment Company Act of 1940 and the Investment Advisers Act of 1940, respectively. ABASA wholeheartedly endorses the bill's preemption of state regulation as it applies to investment companies. Mutual funds, unlike other corporate issuers, are substantively regulated at the federal level. Other members of this panel have pointed out in much detail the regulatory burdens and harmful consequences associated with overlaying "a crazy-quilt of conflicting, duplicative and inconsistent" state regulatory requirements on top of substantive federal regulation. Thus, the need to create a uniform system of regulation for mutual funds is clear, and ABASA strongly agrees with the approach taken by H.R. 2131, namely elimination of all state regulation of mutual fund companies.

We realize the issue is not cut so clearly with respect to investment advisers. As Ranking Minority member Markey and Representative Boucher have publicly pointed out, the Commission currently lacks sufficient resources to adequately supervise and inspect investment advisory firms. Yet, we would note, the need to avoid duplicative, needless, and conflicting regulation is no less important for investment advisers. Federal preemption of duplicative and conflicting state laws with respect to investment advisers is therefore appropriate. Consequently, ABASA would urge the Committee to continue to study the issue and work with all affected parties to arrive at an appropriate solution to this issue.

SUITABILITY

While the Committee's invitation to testify requested that ABASA present testimony on a national system of securities regulation, we would also like to address a few other provisions of H.R. 2131.

Section 2 of the bill would amend Sections 6, 15 and 15A of the Exchange Act to provide that broker-dealers are not liable for the investment decisions of institutional clients, unless a written agreement to the contrary has been reached. Institutional client is defined as "any person other than a natural person that has at least $10,000,000 invested in securities in the aggregate in its portfolio."

This provision is intended to prevent those institutional investors who may seek to recoup any market losses suffered by exploiting suitability rules and concepts. This provision would not affect the current suitability protections afforded to non-institutional investors. Nor would this provision absolve any broker-dealer from liability for fraud committed in connection with the purchase or sale of securities.

As a general matter, ABASA supports the notion that institutional investors are capable of making their own investment decisions independent of any broker-dealer recommendations and, thus, do not need the protections afforded by the securities laws to individual investors. Nor do we believe that broker-dealers should become, in effect, guarantors of investment performance. Consequently, we would support that aspect of the legislation that would allow side-bar agreements to be crafted to cover those limited instances wherein the institutional investor is not sufficiently experienced or capable of making its own investment decision. The key, however, is that the investor must be totally honest with him or herself and recognize the need for the side-bar agreement.

We would note that bank trust departments and trust companies and registered investment advisers, bank affiliated or not, are sufficiently sophisticated that they, too, should be included within the legislation's definition of institutional investor. Bank trust departments, trust companies and registered investment advisers generally do not hold securities in their own investment portfolio, they have [other people's] assets under management. Thus, the definition of institutional should be revised to read "... at least $10 million invested in securities in the aggregate in its portfolio and under management."

ABASA is, however, uncertain about the $10 million invested in securities threshold for determining when an institution is sufficiently capable of making its own investment determinations. On the one hand, we believe that all investors, but espe-

[2] We would note that, in recent months, the NASD and OCC have joined forces to conduct joint inspections/examinations of bank-affiliated mutual funds. We applaud this latest regulatory initiative in reducing regulatory overlap.

cially institutional investors, should not invest in any security product unless they understand the product and how it functions under various market conditions. On the other hand, we note that there will always be some investors who will be tempted to chase yield and ignore other important features of the investment.

In any event, the definition of institutional investor contained in H.R. 2131 would classify approximately one-third of all commercial banks as retail investors having under $10 million invested in securities. As such, these banks would be entitled to protection under the Commission and SRO suitability rules and concepts. We would further note that commercial banks are severely limited by law as to what type, quality and quantity of securities they may hold in their investment portfolios.[3]

WILLIAMS ACT PROVISIONS

Section 5 of the bill would eliminate the five percent beneficial owner reporting, going private transaction and tender offer provisions of the Williams Act.[4] These provisions serve to alert the market about potential and pending tender offers and other corporate reorganizations. By bringing these transactions out into the sunshine, these provisions have done much to encourage investor perception that our markets are fair, orderly and open. ABASA is concerned that repealing the Williams Act will unduly undermine that perception and drive investors away, potentially to other markets.

Repeal of the Williams Act will leave investors with little in the way of protection in this area under federal law. Instead, state takeover statutes will control; and while we agree that issues concerning corporate governance should be a matter for state law, we are concerned that state takeover statutes will put local economic interests ahead of national interests. One can imagine state authorities enacting legislation to prevent certain takeovers from taking place under the theory that while the transaction may be good for the U.S. economy, it would nevertheless be bad for the particular state in that it would cause a loss of both jobs and tax revenues for the local community. Indeed, no less an authority than Louis Loss has suggested that "[t]akeover regulation, today, is arguably the single area of state corporate and securities regulation where consideration of federal preemption would be wisest."[5]

We do, however, believe that amendments can be made to the Williams Act provisions to avoid duplicative reporting requirements. For example, Section 13(d) and the rules promulgated thereunder permit banks and other persons that acquire securities in the ordinary course of their business and not with the intent to control or influence the issuer, to file, on a yearly basis, a Schedule 13G containing beneficial owner information. As with the Schedule 13D filing, the threshold for filing the Schedule 13G is the acquisition of greater than 5% of a class of outstanding shares. Given the amount of assets managed by some of our trust departments, banks are frequent filers of these reports.

In addition, bank trust departments must file reports under Section 13(f) of the Exchange Act. These reports are required whenever the trust department exercises investment discretion with respect to accounts holding exchange traded equity securities or equity securities traded on the NASDAQ that have an aggregate fair market value of $100,000,000. These reports are filed with the Commission on a quarterly basis.

ABASA believes that there is much overlap in the Schedule 13Gs and the 13F Reports. Consequently, we would offer to assist Committee staff and other appropriate parties in developing a new and improved reporting scheme, if, in fact, evidence indicates that one is necessary, that would streamline and reduce current regulatory duplication.

REPEAL OF THE TRUST INDENTURE ACT

Bond trustees are charged with protecting the interests of bondholders. Bond trustees generally do so by making certain all the requirements of the bond issue are satisfied. These requirements are generally set forth in the indenture which specifies the responsibilities of all parties, including the issuer and the trustee. Thus, for example, the indenture will state the amount of interest to be paid, the payment due dates, and the maturity date for the bond issuer, as well as restrictions on the use and investment of funds, and other important covenants.

The indenture also spells out all of the duties of the bond trustee. One of the trustee's most important duties is to see that the issuer keeps its promise to pay

[3] *See e.g.*, 12 U.S.C. 24(7).
[4] Sections 13 (d) and (e) and 14 (d) and (f) of the Exchange Act.
[5] Loss and Seligman, *Fundamentals of Securities Regulation* at 503 (3d ed. 1995).

the bondholders' interest and principal on the due dates. If the issuer cannot or does not honor its commitment to the bondholders or otherwise breaches its duties and responsibilities under the indenture, the bond trustee will notify bondholders of the issuer's default and may take legal action on their behalf.

The Trust Indenture Act (TIA), as amended, generally requires that all indentures be submitted to the Commission for qualification along with the issuer's registration statement. Qualification ensures that the indenture conforms to the TIA and the minimum standards established under that Act. As a result, the TIA sets out minimum standards of conduct for trustees and obligors to follow.

ABASA believes that repealing the TIA will not reduce regulatory burdens associated with bringing a debt issuance to market. Trustees are well-recognized as serving important investor protection needs. Trustees do that by following the appropriate standards of conduct laid out in the TIA. Repeal the TIA and the bond trustee's role in protecting investors will be undermined.

Moreover, the TIA has served a very useful purpose in creating a national uniform and clearly defined standard of conduct for obligors and trustees. In fact, many debt issuances, not subject to the TIA, have been issued under governing documents that incorporate many of the standards and protections for investors outlined in the TIA. Without the TIA, a trustee, if in fact one is selected, will not know what minimum standard of conduct to follow.

The Congress should also consider the potential harms that may be visited on the debt market should the TIA be repealed. Individual investors in corporate debt, as well as securities regulators, have taken comfort for the last fifty-six years that trustees have protected investor interests. Repeal the TIA and investor perceptions may change dramatically and not for the good of the bond market. For example, investors may perceive that because trustees are no longer required on debt issuances, the bond market is no longer as fair, open and orderly as it once was. These investors may choose to take their investment dollars off-shore, much to the detriment of our markets.

Finally, we would note that the minimum standards established by the TIA have been recently overhauled to reflect evolving standards of industry practice and conduct. In 1990, the Congress, with major input from the bond trustee industry, approved the Trust Indenture Reform Act ("TIRA") which modernized the TIA in recognition of the fact that the public market for debt securities had undergone significant changes since the TIA's adoption in 1939.[6] Thus, it would be misguided to repeal the TIA under the theory that it is an outdated law and as a result of these dated provisions imposes innumerable regulatory obstacles to capital formation.

CONCLUSION

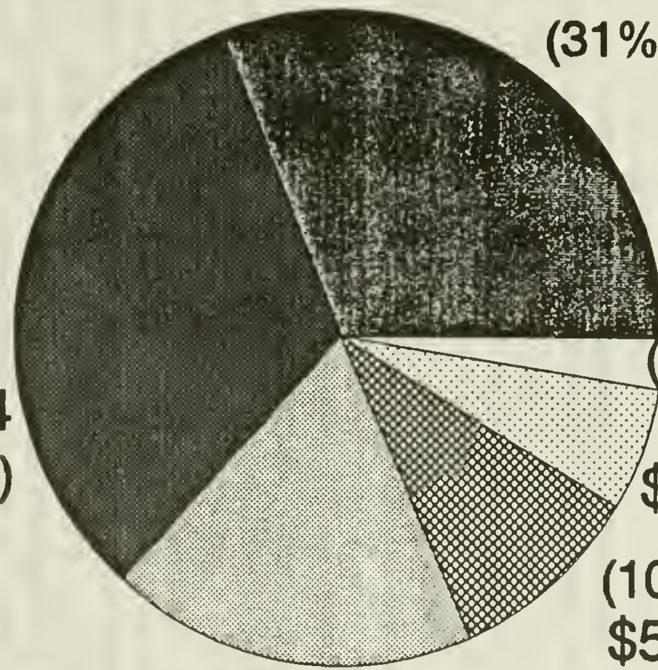
In closing, it has been a privilege to appear before this Committee to discuss these very important issues. ABASA is very supportive of this Committee's efforts to create a unified system of securities regulation and eliminate duplicative and burdensome state regulation. ABASA pledges to work with you, the regulators, and others to take whatever steps are necessary to accomplish these important goals.

At the same time, however, ABASA does not believe that repeal of the Williams Act or the Trust Indenture Act is either necessary or warranted.

[6] Rep. No. 101-155, Senate Committee on Banking, Housing & Urban Affairs (October 2, 1989).

Number of Banks by Securities Holdings

June 1995



Mr. FIELDS. Thank you very much.

Mr. Stephen Friedman, partner, Debevoise and Plimpton.

STATEMENT OF STEPHEN J. FRIEDMAN

Mr. FRIEDMAN. Thank you, Mr. Chairman.

Unlike my colleagues on this panel, I do not represent any trade association. I am a corporate lawyer in private practice. I have served as an SEC commissioner and also as general counsel of one of the largest institutional investors in America, and also a very large securities firm. So I have been on all sides of these issues.

The subcommittee's rethinking of the relative roles of State and Federal regulation is terribly important. Our overlapping jurisdiction, overlapping regulation, and enforcement, should be eliminated.

As Mr. Fink suggested, I think mutual funds are a prime example. But States have played a critical role in the regulation of our securities markets, particularly with smaller broker-dealers and smaller issuers, and that ought not to be lost.

Rather than simply asking the Commission to respond to the specific provisions of H.R. 2131, which are, after all, just one approach to this problem, I think the Commission should come back to the subcommittee with a clear articulation of the principles that ought to govern the allocation of responsibility between the States and the Federal Government and then come back with a program of both regulation and legislation that would implement those principles.

Let me turn to suitability. I will leave to others the definition of institutional client, although I tend to agree that an investment portfolio of $10 million is probably too small a benchmark and that it is possible that more than a financial test may be required. I think the language of section 2 of the bill is seriously flawed, but the subcommittee's objective is wholly appropriate.

The suitability doctrine was developed to impose upon a broker an affirmative obligation to determine a client's needs and objectives and to confine that broker's recommendations to those needs and objectives. In effect, it assumes that in financial matters the broker knows better than the customer what is good for the customer.

Whatever the wisdom of that approach for unsophisticated investors—and I think it is wise—in my view, it has little application to institutional clients. A broker ought to be entitled to assume that the investment officers of a true institution understand the legal and the prudential roles that govern their discretion in administering their portfolio and are operating within them.

The fact is that the nature of risk in the financial markets is both simple and in many respects profoundly misunderstood. It is simple because we have not yet been able to sever the relationship between risk and reward, and so I am perplexed when some institutional investors and corporate officers profess surprise when it becomes clear that the higher returns they have been searching for with unusual instruments are attended by increased risk, and that risk means risk of loss.

I have spent most of the last 20 years on one side or another of the regulation of financial institutions. The most important lesson

of that experience and one that is often ignored or misunderstood is that it is extremely hard to predict precisely the way new financial instruments, and sometimes old financial instruments, are going to perform, and it is hard to predict precisely because it is hard to predict what market conditions are going to be like.

I believe that that inherent difficulty with prediction accounts for a very high percentage of the problems that are developed with new financial instruments, and if that is correct, I see no reason why securities firms dealing in good faith with an institutional client should bear the burden of underwriting the uncertainties of new products during the process that the market uses to test the limits of those products.

Having said that, we are a very long way from saying that a securities firm should have no liability for the investment decision of an institutional client. If the securities firm knows that the investment officer of the client is exceeding his or her authority, or that the instrument as chosen relates to such a large part of the institution's portfolio that it raises real questions of prudence, or if the client is deceived about the nature of the product, the way it functions, or how the investment is doing, then I see no reason why the securities firm should be relieved of liability. This is an area that requires considerably more discussion and understanding before appropriate legislation can be crafted.

I agree that the NASD considerations on suitability have been a disappointment since they are, in effect, a guide to consideration after the fact. The bill would reduce the size of the Commission from three to five members. There is, of course, no magic in the notion of five members, but there is a great deal of benefit to be derived from having a group of commissioners that represent significantly different backgrounds and views.

I can recall a number of occasions during my experience as a commissioner in which the particular background of a commissioner was invaluable in helping the rest of us understand the issues. There is need to have some lawyers, some commissioners with a background in industry, some with a background in finance. It is that breadth and diversity on the Commission itself that informs and ultimately permits the Commission to manage and appraise the recommendations of the staff. If the Commission is too uniform and too small, it is simply not going to be able do that.

Let me close with just a word about the application of the Government in the Sunshine Act, which is not part of the bill. The reason that we have independent regulatory commissions is an assumption that there is benefit to the collective maturing judgment on difficult issues of public policy.

The act has been interpreted to make it impossible, if there is a five-person commission, for three commissioners ever to be in the same room discussing Commission business. If there are only three commissioners either on the Commission or in office, then two commissioners cannot be in the same room discussing Commission business.

I believe that those rules have led to a significant deterioration over the years in the decisionmaking process of the Commission. Those rules don't apply to multimember courts, the Supreme Court, courts of appeals. It is possible for congressmen to talk among

themselves about proposed legislation. Why should they apply to an agency that combines both judicial and legislative functions?

Thank you, Mr. Chairman.

[The prepared statement of Stephen J. Friedman follows:]

PREPARED STATEMENT OF STEPHEN J. FRIEDMAN, PARTNER, DEBEVOISE & PLIMPTON

Chairman Fields and members of this distinguished Subcommittee, I am grateful for your invitation to appear before you this morning to discuss H.R. 2131. I am a member of the law firm of Debevoise & Plimpton and the current chairman of the Committee on Securities Regulation of the Association of the Bar of the City of New York. My comments this morning represent solely my own views and not those of my firm, its clients, the Committee or the Association. The Committee on Securities Regulation has established a special committee to follow the work of this Subcommittee, and we look forward to working with your staff.

I will not rehearse with you this morning the role of the U.S. capital markets in the U.S. and the world economies. Suffice it to say that the U.S. capital markets are enormously strong and healthy and that regulation of those markets has been a significant benefit rather than a detriment to the capital-raising process. It is also worth noting the obvious, but sometimes unstated fact in these debates, that the level of savings and investment are fundamentally the product of our fiscal and monetary policies rather than securities regulation. Regulation imposes costs on the capital-raising process and, at the margin, will affect who has access to those markets and who does not. Since we believe that it is the market that should decide who has access to capital, every effort should be made to make sure that these regulatory costs are justified by important regulatory objectives and that an attempt has been made to find the most targeted and least burdensome way to achieve those objectives.

It is in that context that I believe this Subcommittee has undertaken an important and commendable challenge: to step "outside of the box" and ask the hard questions about whether the way we regulate the securities markets today is the best way to accomplish our objectives. In considering alternative approaches to securities regulation, I suggest that the Subcommittee look closely at the experience of markets outside of the United States. It is true, of course, that each market and regulatory system is the product of the culture and history of its home country; but that fact too often leads to a cursory dismissal of the relevance of the experience of other markets. The fact is that we have before us a series of real-world testing grounds in the markets of the major European countries and Japan, as well as the international Eurodollar markets. Each is an experiment in other approaches to regulation, and you should consider hearing from witnesses who can testify knowledgeably about the relevance of the experience of those markets.

Three other background matters deserve attention. First is the "bad guy problem." When I became a Commissioner of the SEC in 1981, I brought with me a background as a corporate and securities lawyer which had led me to believe, as I believe today, that virtually all businessmen try to conduct their business with a real desire to comply with all applicable laws. The regulatory thicket we have created in our economy sometimes dampens their enthusiasm, but the commitment of American business to its legal and regulatory obligations is impressive, especially in comparison to other developed countries. At the same time, it quickly became apparent to me in a way that I had not fully appreciated before joining the Commission that in our financial markets there is an inevitable quantum of old-fashioned fraud. It is not just a question of "rogue brokers" or what a friend of mine who is general counsel of a securities firm described as "Master of the Universe Wannabees" trading on inside information; it is a question of character and a single-minded devotion to making money as the paramount value in life. Those defects of character represent only a tiny percentage of our society and of those who participate in our capital markets. But their effects can be pernicious and widespread. That is the reason the SEC's Enforcement Division exists and the reason why state enforcement activities are important.

In fact, enforcement activities are an important substitute for, and restraint on, over-regulation. The challenge for the SEC, as in all regulatory activities, is to resist the temptation to deal with the "bad guys" with regulation rather than enforcement. When some very bad conduct comes to light, the typical reaction in our society—and in the Congress as well—is to ask the SEC how it could "permit" such a thing to happen—implicitly asking for a rule or a set of procedures that will make it impossible for that conduct to be repeated. But it is not possible to design rules that only restrain the conduct of the bad guys; they apply to everyone and have the inev-

itable effect of restricting the flexibility of legitimate market participants. Sometimes it is better to recognize that we should respond to egregious conduct when it occurs and punish it severely, relying on deterrence to reduce the likelihood of similar activity.

Second, on the other side of the coin, we should recognize that financial markets tend toward excess and that regulation plays an important role in constraining that tendency. It is classic that as the period of any phase of a cycle lengthens, the quality of the IPO's, of the LBO's, of the junk bonds, of the takeovers, of the real estate limited partnerships, or whatever, tends to deteriorate. This is not a matter of venality; it is matter of the markets' tolerance for the decline in quality being somewhat more elastic than, in retrospect, we always wish it had been. There is no real solution for this tendency; but the disclosure system plays a critical role in helping markets recognize that decline in quality as early as possible.

Third, the last 25 years have been a period of stupendous change in our financial markets. The inflation and interest-rate spikes of the 70s and early 80s worked a sea change in financial instruments and financial markets. Technology has introduced trading strategies the ripple effects of which are yet to be fully understood. The creation of synthetic securities, such as derivatives, tests our comprehension and our ability to foresee the way they will behave. The M&A boom has radically changed our notions of the way our major companies evolve. And globalization of capital raising and trading has broadened the scope of the activity to be regulated beyond the reach of the regulators.

Most of these developments could not be banished, nor should they be; they would not be present if they were not perceived by market participants to perform a useful role. On the other hand, as we have seen, they all present the opportunity for abuse. And the perception of fundamental fairness in our capital markets is critical to their ability to attract capital. This is, accordingly, a time to proceed with extreme care, feeling our way toward the correct balance between freedom and control, and between enforcement and regulation. It is a time for experimentation and assessment of the results of those experiments. It is not a time in which fundamental changes in the regulatory structure should be made without a clear understanding of the consequences.

Mr. Chairman, with that background, I would like to discuss briefly some of the matters covered by the current version of H.R. 2131.

The Role of State Regulation

The Subcommittee's rethinking of the relative roles of state and federal regulation is extremely important. It offers the opportunity to eliminate overlapping regulation and enforcement activities. I should mention parenthetically that there are other overlaps as well. When a securities firm's employees are guilty of some serious lapse, it may find itself dealing with the U.S. Attorney, the SEC, the CFTC, the NASD and stock exchanges, and the state securities regulators. The Subcommittee's review also offers an opportunity for rethinking the role of state regulators in a national financial system in the absence of the kind of direct state interest that flows from state charters of banks, S&Ls and insurance companies. On the other hand, this review also requires a clear assessment of the contribution that has been made to securities regulation and enforcement by state regulators, especially with respect to the activities of smaller issuers and smaller broker-dealers. That role has been a significant one; it could not easily be filled by the SEC and clearly could not be filled at all without a significant increase in the size of the SEC staff.

The introduction of H.R. 2131 has unleashed a process of rethinking the role of federal and state securities regulation: NASAA has appointed a blue ribbon panel and the SEC and various bar association committees are giving the matter serious consideration. This is a clear occasion for the exercise of this Subcommittee's oversight function. Rather than asking the Commission to respond to the specific provisions of H.R. 2131, which represent simply one approach to this set of problems, the Commission should come back to the Subcommittee with a two-pronged response: first, a clear articulation of the principles that the Commission believes should govern the allocation of functions between federal and state securities regulators, and second, a legislative or rule-making program that would implement those principles.

Suitability for Institutional Investors

Section 2 of H.R. 2131 creates a presumption in any action against a broker-dealer

> "pertaining to an investment recommendation to an institutional client [that] the broker or dealer... is not liable for the investment decisions of an institutional client,"

and that presumption may be rebutted by proof that the broker-dealer expressly agreed in writing that the recommendation would be suitable for the institutional client. An institutional client is anyone other than a natural person with a securities portfolio of at least $10 million. I will leave to others the definition of "institutional clients," although I tend to agree that an investment portfolio of $10 million is too small a benchmark.

While I think that the language of Section 2 is seriously flawed, I also believe that the Subcommittee's objective is wholly appropriate. The suitability doctrine was developed to impose upon a broker an affirmative obligation to determine a client's investment objectives and needs, and to confine his or her recommendations to those that are consistent with those objectives and needs. It assumes that, in matters relating to the financial markets, the broker knows more than his or her clients *about what is good for those clients.* Whatever the wisdom of that approach for unsophisticated customers, in my view it has little application to institutional clients. In particular, I do not think that we should impose a responsibility on securities firms to ascertain all of the investment limitations that may be applicable to an institutional client or to decide whether "speculation"—whatever that is—is permissible for the institutional client. A broker should be entitled to presume that the investment officers of an institutional client understand the legal and prudential limitations on their authority and are operating within them.

The fact is that the nature of "risk" in the financial markets is both simple and profoundly misunderstood. It is simple in the sense that we have not yet broken the linkage between risk and return. And I am perplexed when institutional investors and corporate financial officers profess surprise when it becomes clear that the higher returns they have been pursuing with exotic financial instruments are attended by increased risk—and that risk means *risk of loss.*

I have spent most of the last twenty years on one side or another of the regulation of financial institutions—securities firms, banks and life insurance companies. The most important lesson of that experience—and one that is often ignored or misunderstood—is that it is extremely hard to predict precisely the way in which new financial instruments (and sometimes old ones as well) will perform because it is impossible to predict the full range of market conditions. Time and again, the creators of new financial products, acting in good faith, test the performance of those products against a full range of what they believe to be reasonably likely market scenarios. From time to time the markets do not cooperate and what appears to both securities firm and customer to be a foolproof strategy comes unglued, sometimes with reverse leverage. To pick a simple example that does not involve exotic instruments, there have been periods when the volatility of a portfolio of government bonds—which carry no credit risk but substantial market risk—has exceeded the volatility of a portfolio of equity securities.

I believe that this inherent difficulty with prediction accounts for a very high percentage of the problems that have developed with new financial instruments. If that is correct, deciding in retrospect that the strategy was extremely risky (because it turned out that way) and that the securities firm was wrong in recommending it to an institutional client in the first place is just another way of saying that the securities industry should reimburse institutional investors for losses during the period that the markets test the limits of the strategy and learn its uses and its pitfalls. I see no reason why a securities firm, dealing in good faith with an institutional client, should bear that burden.

Having said that, we are still a long distance from saying that the securities firm should have "no liability" for the investment decision of the institutional client. If the securities firm knows that the investment officer of the institutional client is exceeding his or her authority, or that the strategy chosen relates to such a large part of the institutional client's portfolio that serious questions of prudence are raised, or deceives the client about the nature or performance of the investment, I see no reason why the securities firm should be relieved of liability.

The NASD has proposed a set of "considerations" to be taken into account after the fact in deciding whether the suitability obligations in Article III Section 2(a) of its Rules of Fair Practice have been satisfied. Although the considerations listed are certainly relevant, I find them an unsatisfactory guide to future conduct by market participants. As noted above, I believe that, in the case of true financial institutions, the whole notion of suitability is "unsuitable" and that more emphasis should be placed on disclosure and appropriate standards of care in making investment recommendations. I agree with Chairman Levitt, however, that this is an area that requires considerably more discussion and understanding before appropriate legislation can be crafted.

Reduction in the Size of the Commission; Government in the Sunshine Act

Section 9 of H.R. 2121 would reduce the size of the Commission from five to three members. There is, of course, no magic in the notion of five commissioners. But there is considerable benefit to be derived from having a group of commissioners that represent significantly different backgrounds and views. Much more is involved than having different political parties represented. There is a need to have some lawyers, some commissioners with a background in industry and some with a background in finance. It is that breadth and diversity of background that informs, and ultimately provides the basis for managing, the enforcement and regulation-writing activities of the staff.

The recent experience of the Commission with only two commissioners also suggests that three commissioners is too small a group to provide for the inevitable expiration of terms, resignations and change of circumstances that leave vacancies on the Commission.

Finally, I feel constrained to say a word about the impact of the Government in the Sunshine Act. The Act has been interpreted, I believe, to apply whenever a quorum of the Commission is in the same room discussing the work of the Commission. The reason that virtually all of the independent regulatory commissions have a number of commissioners is that it has been believed that the interchange over time of differing views on significant public policy issues will lead to a collective maturing and evolution of views—that ideas should be tested in a collective forum and that frank and open discussion will ultimately yield the best result. It is extremely difficult—I would say impossible—for that kind of discussion to take place in a public meeting of the Commission. Even with a full five members in office, not more than two members of the Commission can have a private discussion about Commission business. The result has been a deterioration in the decision-making process of the Commission, and the problem would be even worse with a three-member commission. These rules do not apply to the Federal Courts of Appeal or to the Supreme Court; they do not apply to Congressional committees; why should they apply to an agency that combines both judicial and legislative functions?

Tender Offers

No area has been the subject of more rapid evolution than market practices dealing with the acquisition of companies in the public marketplace. Current market practices are the result of the interplay between state corporate and antitakeover laws and the federal securities laws. I believe that the current system reflects a fair balance between offense and defense and that the interests of shareholders are fairly balanced with those of the corporate entity. Any wholesale change in the rules, such as that contemplated by Section 5, is likely to upset that balance. Accordingly, changes should be made only to the extent necessary to remedy clearly defined problems.

Mr. Chairman, that concludes my testimony. I would be pleased to answer any questions that members of the Subcommittee may have.

Mr. FIELDS. Thank you, Mr. Friedman.

The Chair will recognize himself for 5 minutes.

Let me repeat at the outset that this is a work in progress. It is not in the interests of the Chair nor anyone on this panel to compromise investor protection and do anything that makes the market anything less than transparent. On the other hand, we are talking about laws that are 55 years old and older. I think this is a historic opportunity to put everything on the table and discuss how those laws function in today's marketplace.

So consequently, the Chair is not interested in reform for just the sake of reform. To me, there has to be something that actually needs to be done; there needs to be waste or duplication eliminated. Let me begin with that, and I will ask the entire panel, how does the current overlapping Federal-State regulatory system create waste and duplication?

Mr. Krongard?

Mr. KRONGARD. First of all, I think the most important thing I think all the panelists here would agree upon that we would all

like to see is the majority of the emphasis be placed on the detection and the elimination of fraud in the marketplace.

So to the extent, for example, that State securities regulators can concentrate on that and not do what is essentially a duplicative effort in repeating the efforts of the Federal Government or SROs, that would enable them to focus their attentions where they could best serve their residents.

Second, what you have seen, the so-called blue chip exemption that was mentioned before, is a relatively recent phenomenon that can be opted out by any State. What we would like to see is that codified by the Federal Government.

I came up through the investment banking side of our business, and the blue sky stories that anyone who did what I did could relate from various States holding up securities that you are waiting to issue are legion.

And finally, you have an example of a State like Florida that tacks on something to a securities registration process having to do with doing business with Cuba to satisfy local internal politics that have nothing to do with the financial risk of the security.

It is those sorts of things that we are trying to eliminate and to get the States to do what they do best, which is protect their residents by concentrating on the fraud aspects.

Mr. FIELDS. Ms. LaRoche.

Ms. LAROCHE. Thank you.

As we all know, regulation and duplicative regulation in any form increase costs for everyone.

Another point that we should stress is that as the world's financial and capital markets have become global and in many respects fungible, we have got to recognize that we should be competing on brains, on efficiency of our markets, and on transparency, and not on duplicative regulation that creates greater disadvantages for us.

Mr. FIELDS. I might also ask, if anyone just wants to talk about cost, CRS—Congressional Research Service—arrived at an estimate for the total legal administrative cost of blue sky security issues of $260 million on the lower side, and between $430 and $600 million on the upper side. That is compliance costs.

Mr. Gaine, you also in your testimony talked about that it sometimes takes as long as 4 months to get clearance.

Mr. GAINE. This would certainly be one of the costs. There are opportunity costs; that would be an example of that. There is a further opportunity cost in that, given the 51 chefs in the kitchen, you have to come to the lowest common denominator in innovation and development of a new feature of your investment vehicle. And perhaps the most real cost is that, for a large commodity pool, there is approximately $300,000 will relate to legal fees and expenses to startup a large public pool. About $100,000 or more of that would be devoted to blue sky clearance, and, as I said in the written testimony earlier, with no public benefit. We have the SEC and the CFTC——

Mr. FIELDS. So it is a third of the cost that gets passed on, I assume.

Mr. GAINE. That goes right to the investor. My numbers are generous, but not——

Mr. FIELDS. Mr. Fink.

Mr. FINK. Thank you, Mr. Chairman.

Well, for duplication and waste, you have fund prospectuses that are all cleared by the SEC every year, but then a bunch of States decide they want to clear and review and require other, so that is redundant.

Advertising: For an advertising filed with the NASD and cleared, but you have a handful of States that want to review it again.

Investment limitations: The Investment Company Act dictates fund portfolio limits, but a handful of States decide to impose their own.

I frankly wouldn't be as upset if it was just waste and duplication. That is a part of life in a Federal system to some degree. But I think it has harm to investors.

You have prospectuses that are mucked up because you have 10 or 12 different agencies dictating what has to go in them in an uncoordinated manner. You have new products, innovations, cleared by the SEC, permitted by probable law, that would help investors, that are blocked by one State.

So waste and duplication is bad enough, but there is a more substantial harm to investors even than that.

Mr. FIELDS. Mr. Shufeldt, very quickly.

Mr. SHUFELDT. Mr. Chairman, I could just say that the designation of the primary SRO would be a big help to us. We as a section 20 sub and a retail broker-dealer, we have multiple regulatory bodies looking over our shoulders. That would be significant.

Mr. FIELDS. Mr. Friedman, anything to add?

Mr. FRIEDMAN. Just that the problem of the primary allocation is made at the State level, and so in order to determine what rules apply, you have got to look at the rules in 50 States. If there were Federal legislation allocating assistance to States in some areas, it would both simplify and lessen the cost of the process.

Mr. FIELDS. Ms. LaRoche, let me turn to you very quickly. You said something in your testimony that the suitability as it has applied today costs the investors in the economy billions of dollars. Could you elaborate?

Ms. LAROCHE. This goes back to the issue of confusion, lack of clarity with respect to coverage, and therefore since there is ambiguity in the marketplace with respect to just what we were talking about, any of this can increase the potential for suits or threats of action. It also increases compliance costs. If there was clarity as opposed to ambiguity as to the respective roles of the participants, you would find those costs would decrease.

Mr. FIELDS. Did I hear you correctly? It was billions? Did you say billions?

Ms. LAROCHE. Yes, we talked about market inefficiencies on a global basis. That is correct.

Mr. FIELDS. Billions of dollars.

The Chair's time has expired. The gentleman from Massachusetts, Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

We have already covered a lot of this ground in a comprehensive fashion over the last 3 years. As you know, we had a comprehensive set of hearings, about a half dozen hearings on the government securities legislation that passed in 1993. We have had expert wit-

nesses who have looked at the history of this entire area in an extremely comprehensive way, and in fact produced a piece of legislation on this subject in 1993, as an update of the 1986 act which passed out of this committee after exhaustive hearings on the subject.

So we have absolutely covered the waterfront on this particular subject in very recent years. In fact, the NASD and the Securities and Exchange Commission have proposed rules out on the streets right now pursuant to the 1993 act, I think as everyone here knows.

So that when you say it is the first look at it in 50 years, I wish that you would amend your comments henceforth, because you know that is inaccurate, and it basically does not reflect the history of this committee, where each of the panelists here were asked to testify on the subjects during those hearings that took place just in recent years.

As a matter of fact, did the PSA, Ms. LaRoche, oppose the legislation in its final form, the 1993 act?

Ms. LaRoche. Absolutely not, sir, and the Government Securities Act of 1993 was a compromise package that PSA did support.

Our concern about the specific provisions dealing with the treatment of institutional investors was clearly stated at that time and continues today. In fact, our positions are consistent. The biggest issue in 1993 was the removing of the prohibition that had been on the NASD to adopt sales practice rules in the government securities market. We supported lifting that prohibition then and continue to think it is appropriate. We have attached to our testimony our comment letter with respect to the NASD proposal. We supported its philosophy and thrust. However, we do feel there still would be ambiguity and there would be lack of clarity.

Specifically, we believe that with respect to three issues, the presence of an investment advisor if transactions are executed consistent with guidelines or the presence of a written agreement, that any, all, or either of these three should be determinative in and of themselves of a dealer's suitability obligation.

Mr. Markey. So you are not trying to repeal the 1993 Government Securities Act?

Ms. LaRoche. Absolutely not.

Mr. Markey. The suitability requirements.

I guess what my concern is, that the issues, as I recall it back in 1993 as we were negotiating with PSA, were the issues of price transparency and the issues of large position reporting. This issue of sales practices really was not in contention at the time.

What my concern is, that with the rise in concern about derivatives and the inappropriateness in many instances of the sale of derivatives to smaller towns, especially, to those that might look to the whole world as though they are sophisticated investors but in reality they are just towns of 20 or 30 or 40,000 people with a part-time town treasurer who is relying upon the investment firm that they hired to put them into the proper products.

But when you put someone into an inverse floater or a butterfly spread or an IO or a PO or a CMO or—a town treasurer doesn't understand these vehicles at all and are completely dependent

upon the confidence which they have in the investment firm putting them into a proper product.

And a lot of this, I am afraid, rises in the aftermath of that kind of product being marketed to these kinds of smaller towns and other so-called institutional investors, but not those that can properly understand the volatility of the device, and I guess that is the heart of my problem in looking at this particular set of issues.

Ms. LaRoche. Let me respond as a citizen as well as a taxpayer. First of all, managing someone else's money should never be a part-time job. In fact——

Mr. Markey. But it is. I mean I can't tell you——

Ms. LaRoche. In 1991 the PSA stated, "Governmental entities charged with a duty of filling a public trust must have adequate resources to satisfy their responsibilities. Lack of resources cannot serve as a basis for shifting their responsibilities to the marketplace."

Mr. Markey. Well, that might be—you know, that might be nice to state, and I think that in fact the rules that the NASD and the SEC have out on the street kind of reflect that. I mean they put $10 million as the place at which someone does become a sophisticated investor, but they have got a list of criteria which are then used to mitigate, depending upon the circumstances, and if you happen to be the part-time treasurer of a town of 20,000 people, depending upon some roving 27-year-old salesman of butterfly spreads, you could be in a little trouble if that salesman happens to have conned you over a series of dinners at the most expensive restaurants that you have ever been taken to in downtown. And I don't think that necessarily that town should have forgone all of its subsequent rights to be able to sue.

Do you agree with that?

Ms. LaRoche. No, I don't agree, and let me make two observations.

First of all, we need to distinguish between investment products and investment strategies, because quite frankly, sir, putting a 30-year U.S. Government bond into a short-term cash portfolio would also be a very inappropriate investment and nonsuitable investment under certain circumstances.

With respect to the ability of a town as you mention here or any other entity to be able to judge or pay for independent investment advisor services, let's all be cognizant of the fact, this country does have a very broad, as Mr. Fink has indicated, mutual fund industry that does allow for the investment of public or private funds into mutual funds that provide for professional expertise as well as the diversification of risk and products.

Mr. Markey. I appreciate that.

Let me ask this. You say in your statement on page 5 that the PSA is concerned that market participants are increasingly and inappropriately misusing the rule and the suitability concept to effectively and practically make a dealer the guarantor of an investment's performance.

Can you give us a specific example of where that has happened?

Ms. LaRoche. Well, I think that we have all—we have all read in the press of specific examples. I am sure the staff would be willing to talk with your staff.

Mr. MARKEY. No. I would like you to give us the specific examples that you are referring to.

Ms. LAROCHE. I think the content is this——

Mr. MARKEY. No, no. Can you give us a specific example in your own experience that you consider to be a use of this rule as a guarantee? And what are you basing this upon, your testimony? Can you give us an example, one example, just one example, anywhere?

Ms. LAROCHE. Well, without going into specifics because——

Mr. MARKEY. No, no. I need one specific.

Ms. LAROCHE. I think that the well publicized issues of a large county in California would in fact relate to this.

Mr. MARKEY. You think that Orange County—you think the suit against Orange County based upon—using the fraud statute, is in fact inappropriate?

Ms. LAROCHE. No, I did not say that. You wanted to know what were circumstances where issues of suitability as to instruments or as to investment strategies did——

Mr. MARKEY. They are not alleging violation of suitability requirements in Orange County. That is a fraud suit.

Ms. LAROCHE. That is correct, absolutely, but there has been a question that has been raised in the press as to the suitability——

Mr. MARKEY. I asked for a specific example where the suitability requirements have been used as a guarantor.

Mr. FIELDS. The gentleman's time has expired. Maybe Ms. LaRoche can provide that specific example.

Ms. LAROCHE. Absolutely, we would be pleased to do that.

Mr. FIELDS. The gentleman from Washington State.

Mr. WHITE. Thank you very much, Mr. Chairman. I appreciate it very much.

Ms. LaRoche, just to follow up a bit on this testimony, in your opinion, when it comes right down to it, is it the responsibility of the broker or the person making the investment to determine what sort of investment is appropriate to them? In our system, how does that normally work?

Ms. LAROCHE. Are you speaking with respect to an institution or an individual? I am sorry.

Mr. WHITE. Well, in either case. Where is the fundamental responsibility?

Ms. LAROCHE. Ultimately, the individual or the institution needs to understand the circumstances with respect to their financial situation, their tax situation, as well as their investment horizons and their investment perspectives.

As an individual, or in this case the assumption of someone having an institution having less than $10 million, the assumption is that they are not sophisticated, but they do not have the capacity to be able to deal with this. With respect to institutions over that amount of money, the assumption is that they do have that capacity.

Institutions today invest money around the world. An institution does not have one person that invests that money. An institution may have 50 or 100 separate portfolio managers investing in different types of portfolios for different types of ultimate clients. That is the nature of the complexity of the marketplace.

Mr. FIELDS. Will the gentleman yield?

Mr. WHITE. I would be happy to yield.

Mr. FIELDS. Just very quickly, to follow up on this point, you mentioned several times in your testimony and in your response to questions the need for clarity and that when we are talking about an institutional investor, someone who is sophisticated in the marketplace, there is that opportunity to contract as to what the suitability obligation is.

Ms. LAROCHE. Absolutely. If they wish to deem that they are unsophisticated and wish to be treated as an unsophisticated investor, if he can so contract with me. Human nature and human beings what—being who we are, let's just think, how many people have ever stood up and said, you know, "I really don't understand this; I am unsophisticated"?

Mr. FIELDS. I thank the gentleman.

Mr. WHITE. Okay. Thank you. I thank the chairman.

Let me ask you just one other question, Ms. LaRoche. Then I have a question for Mr. Krongard. Do you think we ever run the risk perhaps of lulling investors into a false sense of security?

I mean, if investors really think that the Government and their brokers and other advisors are going to make the final decision and are only looking out for their interests, doesn't that get us a little bit away from the basic concept that our security system is based on? I am just interested in your thoughts on that.

Ms. LAROCHE. Absolutely. I believe both Chairman Levitt and Chairman Greenspan last week testified to that, that the presumption of an arm's length transaction between the institutional investor and the broker-dealer is one of the basic hallmarking tenets, because you can only protect yourself the best to a certain extent, and otherwise one becomes an insurer or guarantor.

To do that, quite frankly, there are other mechanisms in our financial services industry where one could buy, indeed, insurance.

Mr. WHITE. I appreciate that. It certainly seems to me, if you get too far down the pike, you really do blur the distinction. I think that can create more problems than it solves.

Mr. Krongard, let me ask you a question. Part of your testimony talked about the fact that we have seen a decline in the relative share of the U.S. equity markets with respect to other equity markets around the world, and I would like to get your thoughts and why you think that is, and whether one of the primary factors is the burdensome regulation that you might find in our market or whether there are other factors that are equally significant.

We certainly do have good, efficient markets here. I would just like your considered judgment on why you think this decline has taken place.

Mr. KRONGARD. Yes, sir, I think it is a combination of things.

First of all, there are more investment opportunities around the world. Money will always go to the place where it thinks it can do the best. There are growth rates in certain developing countries, along with much higher risk, nevertheless that to some people offer higher return for a certain amount of international money.

Second, sophistication in international markets, particularly upon European investors where they make currency bets rather than market bets. They don't like the direction of the dollar. They don't like the stability of the dollar. They don't like the inflation

rates. They don't like some of our debt problems in this country; what they are really doing is betting against the economy here or betting for the economy somewhere else.

The thing that continues to attract money to this country, No. 1, is the incredible integrity of our marketplace, its efficiency, and the drive and dynamics of American business creating new products and services.

Mr. WHITE. None of us want to do anything to affect that, obviously. What we would like to do is try to make it more efficient and improve it to the extent we can. If you could just give us a ballpark number, what percentage or what proportion of this diminution can be attributed to excessive regulation or excessive cost in our market? Probably hard to quantitate, but can you just give me how important you think it is?

Mr. KRONGARD. I probably couldn't make a guess, but when in doubt always go with 10 percent.

Mr. WHITE. That is probably about as accurate as we are going to get. I appreciate that.

Let's see, Mr. Shufeldt, I had a question for you. You mentioned that you didn't support the concept of repealing the Williams Act, and made the point that you think the Williams Act at least contributes to the perception that our markets are fair. And I think it is of course important to make sure we have the right perception, but it is also important to make sure that the reality is the case. If investors have an erroneous perception, I don't think we need to necessarily develop laws based on a perception that isn't grounded in reality.

Just in terms of what the Williams Act really does and how effective it is, disregarding perception, do you still hold to your view that we shouldn't change it or do you think it is really just a perception thing?

Mr. SHUFELDT. I think that it is fair to say that it goes beyond perception. We think it provides some real protection, and although there could be changes made to the act that might improve upon it, make it more efficient, that it is a protection that needs to be there.

Mr. WHITE. Okay, appreciate it.

Thank you very much. Mr. Chairman, I would yield back the balance of my time.

Mr. FIELDS. The gentleman yields back. The gentleman from New York, Mr. Manton.

Mr. MANTON. Thank you, Mr. Chairman.

Just going to the Williams Act for a minute, Mr. Shufeldt, in your testimony you indicated you are opposed to the repeal, and I think Mr. Friedman as well. Could you articulate a little more? You didn't say much about it in your brief summary.

Mr. SHUFELDT. Well, I think our concern gets back to the fact that this could be something that would fall between the cracks, that there is a role perhaps for more Federal intervention in this area and we are not comfortable leaving it completely up to the States, that is really what it boils down to, and it does provide protection we think that is important.

Mr. MANTON. Mr. Friedman?

Mr. FRIEDMAN. Yes, the basic proposal of the bill would be to repeal various disclosure requirements that are required of people who take large positions in prospective targets.

This sector of the market, what I call the takeover sector of the market, is probably the most rapidly innovating and changing one that we have. And every rule, both State corporate rules and the Federal securities laws, have had a major impact on the way people act on the balance between offense and defense, upon tactics, and therefore ultimately on the welfare of shareholders.

My own judgment is that the current state of affairs, which is probably not in permanent equilibrium, but the current state of affairs is a pretty good one. There is a pretty good balance between offense and defense. I think shareholders are in a position where they are getting very high prices on the one hand. On the other hand, there is still room for management to resist takeovers.

I believe very strongly, Mr. Manton, that any change in an important role, and the bill would change some very important roles, is going to change that balance in ways that we cannot predict at all, and my judgment is that that is unwise.

Mr. MANTON. Thank you.

Ms. LaRoche, do you have a strong position on the Williams Act repeal?

Ms. LAROCHE. In fact, sir, the executive committee of the PSA Corporate Bond Committee is in the process of reviewing it. It has not prepared a position at this time, but we will submit it to the committee once it is complete. Thank you.

Mr. MANTON. Thank you.

Mr. Krongard, you have—you didn't really say too much on this.

Mr. KRONGARD. That is the first time anyone has ever said that. But I thank you.

On the Williams Act, I personally would be supportive of Mr. Markey's view that the time interval should be shortened. The only major change I would like to see in the Williams Act at the moment would be a differentiation between people who accumulate large positions of securities for purposes of a takeover and people like large mutual funds that are strictly passive investors. I am not sure they should be burdened with the same kind of requirements that a hostile takeover artist should be.

Mr. MANTON. Mr. Gaine or Mr. Fink, do you have any strong feelings?

Mr. FINK. We have not looked at it. My instinct tells me Mr. Friedman is about right, that there is probably a pretty good balance right in and out. And I would be hesitant to throw a national economic issue to the States. But we have not taken a position on it.

Mr. GAINE. Neither has the MFA, Mr. Manton.

Mr. MANTON. Just finally, not to beat the horse too much here on suitability, Ms. LaRoche indicated human nature would somehow inhibit people from confessing a certain amount of ignorance and saying, I do not know what I am doing, so therefore please help me.

Can we in any way use a more subjective approach to determine whether, in fact, one is really qualified to be an institutional investor who must depend on their own resources?

Should there be a checklist or some kind of investigation of people who come in who have the 10 million threshold but perhaps are a nonprofit organization or a State or local government subdivision as the investor? Should there be a responsibility to inquire at the beginning of the relationship?

Ms. LaRoche. We recognize that there has been—some issues have been raised as to the point that you make. I think the issue is one of what party would in fact do that investigation. As we have stated, we do not believe that it is the role and function of the broker-dealers to in fact do so.

With due respect to certification, I would obviously, you know, bring—I would like to make the point that broker-dealers indeed certified by SROs, other than through the suitability issues, they are in fact bound to legal and ethical standards in facilitating transactions. They have the securities rules and regulations to abide by. In fact, in all the participants in these marketplaces, the broker-dealers do have the highest level of certification and there is some issue with respect both to investment advisers and institutional investors.

Mr. Manton. But your last point on that is that——

Ms. LaRoche. It is an appropriate question that probably deserves further discussion.

Mr. Manton. Thank you. I yield back.

Mr. Fields. The gentleman's time has expired. The gentleman from Ohio, Mr. Gillmor.

Mr. Gillmor. Thank you, Mr. Chairman. I will direct this to all the panel.

The vast majority of States have various antitakeover provisions, opportunities for poison pills and so forth. I think most of us that came out of the legislature at one point or another probably faced this issue at the State level. And my impression was that the driving force behind this was not so much shareholder protection, as it was management protection, to avoid a takeover. So I guess my question is, in your opinion what has been the practical effect of these antitakeover provisions?

Mr. Krongard. Nothing. First of all, there is no such thing as a hostile takeover. There is only inadequate price. Because all these things, as soon as the price gets right, suddenly turn into love affairs. So I would agree that those laws were generated by either management protection or the attempts of States to keep headquarters of corporations in their States. I think at the end of the day, there was no real practical—a lot of litigation expense and a lot of needless chatter, but no real practical effect.

Mr. Gillmor. So you would disagree with the proposition that some have made that we have a management that may have a relatively low financial stake shareholder-wise, but perhaps a large stake salary-wise, that that wouldn't have any effect?

Mr. Krongard. No, what I am saying is that the interests of shareholders was rarely the reason for those laws, and that sooner or later the efficiency of the marketplace will come and get those companies and the price will go up, the shareholders will find a way around, the company will change hands, and the efficiency of the marketplace will rule again. It just takes time to do it, and the

kinds of laws that you describe are impediments to the efficient operation of the marketplace.

Mr. GILLMOR. So they are not really deal killers, but they might——

Mr. KRONGARD. Just raise the price and time. And sometimes they hurt the stockholders because people that are willing to pay up will say, well, why break my ax on this, I will go to somewhere else. So I think rarely are they helpful.

Mr. GILLMOR. Let me ask you a question on an area of margin requirements, which basically grew out of the Great Depression. Some have made the allegation that the current set of margin laws don't set—or don't fit today's global economy and I am wondering if you would agree with that assessment.

Mr. KRONGARD. Yes, I would very much.

Mr. GILLMOR. I have a two part question, part one, what would you do about it, and two, to what extent do you think firms are able to gauge their own credit risks?

Mr. KRONGARD. In typical investment banking fashion, let me answer the second question first.

Today, by virtue of having seen what happens to firms that do not keep a close eye on their own economics, they go out of business. People are much more concerned and risk management is the order of the day.

Second, one has the technology, both in telecommunications and computer and software programs, to in a virtual timeframe on line, manage inventories.

Third, the biggest change in my opinion in margin today, compared to years ago, is that typically today margin loans are not being used to purchase more securities. They are being used just in the same way that normal, you would think commercial bank lending is, to pay college tuitions, income taxes, buy a second home and all that. So you don't have that leverage factor that is generally associated with margin.

Your first question, sir, the globalization of the marketplace, people will seek capital where it is cheapest to get. And places outside the United States that do not have some of the burdensome margin requirements that we do and that understand I think better the dynamics of the marketplace and are concerned with what I call net risk rather than gross risk, it just makes for a more efficient borrowing, and I think that is going to hurt us in the long run.

Mr. GILLMOR. So basically the classic argument for margin requirements, that you are going to prevent excessive speculation, that is really not needed?

Mr. KRONGARD. I do not think so.

Mr. GILLMOR. Let me bring, if I might, Mr. Shufeldt into this regarding margin rules with banks and members of the security industry. Are the regulations the same on margins?

Mr. SHUFELDT. I believe we have different rules, but the effect is the same, the regulation is the same. And I would really defer—I think Mr. Greenspan testified on the margin issues last week and we would agree with him wholeheartedly.

Mr. GILLMOR. Would you agree with that, that the end result, there is no difference really in the banking and securities industry on the net effect of the margin requirements?

Mr. KRONGARD. Yes, although there is so much up in the air now, until Glass-Steagall is resolved one way or the other, I withhold judgment.

Mr. GILLMOR. Let me ask just one other question, if I could, because I am running out of time. It is not directly apropos, but it does involve billions of dollars in public corporations.

There have been some who have suggested, including me, that it might be a good idea in terms of charitable contributions by public corporations to let the determiner of the recipient of those contributions be the shareholder, as opposed to the management. Could you just give me any thoughts on that issue?

Mr. KRONGARD. Yes, of course Warren Buffett does that. And we are a publicly traded company on the New York Stock Exchange. We have something similar to that. I am personally all in favor of it.

Mr. GILLMOR. Can we just quickly run down, any of those who have an opinion?

Mr. FRIEDMAN. I would make one comment, if I may?

The purpose of corporate contributions is to serve interests in the company, and there are examples when contributions have both an important public relations effect and also an important effect on the role of a company in a community. If you let shareholders do it, money will go in quite different directions and serve different interests. So the problem is one I think of abuse from time to time, among companies, rather than there being no legitimate justification for corporate contributions.

Mr. GILLMOR. My time is expired. Thank you.

Mr. FIELDS. The gentleman's time has expired. The gentleman from Pennsylvania, Mr. Klink.

Mr. KLINK. I thank the Chairman, and let me apologize to the panel, I want to jump around a little bit because I want to try to plug some holes.

Mr. Krongard, I want to make sure I understand your testimony and also your response to Chairman Fields. If blue chip exemptions from State review requirements are not a panacea, as I think you suggested, would a national blue chip exemption solve the problem, do you think?

Mr. KRONGARD. Like cited by Congress?

Mr. KLINK. Yes.

Mr. KRONGARD. Yes, sir, yes. The situation today is not nearly as bad as it was. What we are afraid of is individual States, A, either opting out of the arrangement, or, B, adding their little nuances, the example I gave of Florida being one.

If the Federal Government were to lay down one law and that was it, that we could live with, and the States were bound by it also, that would be a gigantic step forward.

Mr. KLINK. Should the States be consulted in the form—should the States have some input on this, do you think?

Mr. KRONGARD. Certainly.

Mr. KLINK. Mr. Fink, you suggest Federal regulation of mutual funds' prospectus, advertising and structure with States concentrating on fraud, sales practice abuses, investor education. Isn't that in essence what Mr. Fields' investment company legislation provides?

Mr. FINK. Investment company, the other bill, sir?

Mr. KLINK. Yes.

Mr. FINK. There is no dealing with States in the other bill, H.R. 1495.

Mr. KLINK. Could we deal with mutual funds outside of H.R. 2131, do you think, effectively?

Mr. FINK. Yes, you could deal with it. You could deal with it in H.R. 2131 or you could deal with it in H.R. 1495 or you could deal with it in other ways, probably.

Mr. KLINK. Okay. Ms. LaRoche, I am still interested in following up on some of your comments a few moments ago. This is something that came up at the hearing last week when we were talking to Chairman Levitt, Chairman Greenspan, mostly Chairman Levitt.

What is the chance if we eliminate virtually all the restrictions on the use of margin that portfolios are going to become more leveraged and the stock market will become significantly more volatile? Is it possible that volatility of the markets would increase substantially if we adopt the margin approach that is put forward in H.R. 2131?

Ms. LAROCHE. Sir, let me respond to that. First, I would like to clarify, because I think the committee was left with a misimpression with respect to there does presently exist a disparate treatment between the margin requirements for banks and securities firms, and securities firms are at present disadvantaged with the existing margin requirements. Banks are not subject to credit regulations with respect to debt. That point should be clarified.

With respect to your point as to the effect of margin requirements or their removal with respect to volatility, quite frankly, I must respectfully support the conclusion of Mr. Greenspan and his band of economists who I do believe here testified that the issue of margin is not an issue of volatility, but is an issue of safety and soundness. So with that, I think that he does have greater expertise in this.

Mr. KLINK. Let me just follow up too, because you mentioned a few moments ago in your response to a question by Mr. Markey about Orange County, and I wonder if you agree about whether the potential dangers created by excessive leveraging of a portfolio were fairly illustrated in Orange County.

In Orange County, we didn't use margin loans to achieve the leverage. Instead we used derivatives. But I think otherwise the analysis may be similar. You may disagree, and express it if you do, but in Orange County, the Treasurer invested $7 billion on behalf of about 130 different entities, mostly they were cities and towns and school districts, and then to try to increase these earnings, he borrowed another $14 billion, double the amount that he was entrusted with, and invested those proceeds. But the Treasurer lost his gamble last year, leading the county to declare bankruptcy.

The county lost almost $600 million of the money that it received from the towns and school districts, which was bad enough, but then Orange County lost $1.2 billion more on the money that he borrowed. Imagine if Orange County had been permitted to borrow

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eight times the amount that it had been given by the towns, instead of double the amount. The entire 7 billion fund would have been lost.

I assume, first of all, my intention is correct and my math is correct, is this the outcome—should this outcome have us concerned, and is this a preview of the kind of modernized capital markets that we want to pass on to our children?

Ms. LAROCHE. Sir, I cannot comment specifically with respect to the facts and circumstances surrounding Orange County, but let me make a couple of points.

No. 1, leverage in and of itself is not bad. It is how it is applied and that is the difference between a wise investment product and a failed investment strategy. We cannot and you cannot legislate unwise investment decisions, nor can we protect people from themselves.

With respect to the question that Mr. Markey raised of me, perhaps I was inarticulate in my response. He was asking me for specific examples of legal actions. The PSA stands by its comment letter which we filed last week, which was developed collectively with over 50 firms based on their experiences from the extreme bear markets in 1995. There are, indeed, many pending actions relating.

Mr. KLINK. Ms. LaRoche, I see my yellow light has come on. Let me ask one question before I run out of time. I think I understand where you are going, and I apologize, but the clock is both of our enemies. It seems, counsel reminded me, and I think I remember, too, that your firm, Morgan Stanley, worked out an agreement with the SEC earlier this year on margin, and my question is simply this, if so, why should we substitute that agreement for the margin provision in H.R. 2131?

Ms. LAROCHE. That is correct, that there was an agreement among three firms with respect to margin. The PSA's perspective on this supports that Levitt proposal. However, the PSA's member firms of over 300 firms do believe that the Levitt proposal does not go far enough. So it is really an issue of degree, with respect to this area.

Mr. KLINK. Thank you. And, Mr. Chairman, I am not color-blind, I see the red light.

Mr. OXLEY [presiding]. The gentleman's time is expired. The gentlelady from California.

Ms. ESHOO. Thank you, Mr. Chairman, and thank you to the panel once again.

To Mr. Krongard, I have a hypothetical question about a national market system that I would like to have you consider. It is about the importance of creating a unified national market system for securities in this country.

Let's assume that this bill, H.R. 2131, were enacted into law as written. The stockbroker in Kalamazoo called a family in Kalamazoo, tried to sell them stock in a small Michigan company. A preemption of State investor protection laws in this bill would mean that the transaction would be governed almost entirely by Federal law. Neither the local broker nor the small company would be subject to any independent registration or licensing requirements by the State of Michigan, and both of them, along with the

local investor, would have to look to Washington if they had any problems.

On the other hand, consider the effect of H.R. 2131 where someone like Kirk Kerkorian to launch a hostile tender offer for Chrysler. Chrysler is a huge, multinational corporation that obviously does a lot of business in Michigan. But Chrysler also has millions of shareholders and does business in virtually every city and town throughout the United States. Nevertheless, H.R. 2131's repeal of the Williams Act would mean that Federal law would be entirely silent as to the rights and responsibilities of the respective parties to this multibillion-dollar transaction. So not only would Federal law be irrelevant, Michigan's laws would likely be irrelevant as well. That is because the law that would govern the transaction would likely depend on whether Chrysler is incorporated, which in all likelihood is in the State of Delaware.

So if my analysis is correct here, then H.R. 2131 would have the result of giving the Federal Government virtually complete regulatory authority over matters of local interest, like the small brokerage transaction in Kalamazoo, but would give—but it would give a few individual States virtually complete regulatory authority over matters of tremendous national importance, like the merger and takeover of many of the country's largest and most important industrial companies.

So my question to you is whether in your judgment this would result in the national market system, in a national market system for securities that are supposed to be the object of the legislation, and is this a desirable and sensible allocation of State and Federal responsibilities?

Mr. KRONGARD. I am sorry, would you repeat the question, please? The last time I had a question like that, it was on my bar course.

Ms. ESHOO. Your answer is 10 percent.

Mr. KRONGARD. First, as I said earlier, the Williams Act repeal for that kind of purpose is not something we support. As Chairman Fields said, this is a beginning, and to put some of this up for discussion, but clearly, the case of the Chrysler takeover should be looked at.

As far as the intrastate Michigan situation is concerned, I would say the following: A, the States, we are not—if the States want to have registration in the State, that is fine, so long as the registration requirements essentially are the same in all the States. They can still be credited with a fee. In fact, the national registration with the elimination of a lot of overhead may even permit greater fees to the States.

And finally, what personally, as someone concerned about the operation of the marketplace on behalf of the Michigan resident, we would love to see the tremendous resources of the State put on fraud detection, rather than some of these other things which are essentially bureaucratic, so that to the extent that it is a clean offering and a clean securities transaction, it ought to be transparent in Michigan and proceed without any interference or really interplay with the local blue sky people in Michigan. To the extent that there is something wrong with that transaction, then I would love to see, I think that is exactly the kind of instance where the State

blue sky people could play the principal, the signal role in detecting and punishing those responsible for that.

Ms. ESHOO. Thank you. In your view, do the States today have the capabilities to move into the fraud areas that you just touched on?

Mr. KRONGARD. It really varies greatly from State to State. There is not near—I am a big fan of the SEC's, and I think one of the strongest points about the Commission is the stability of its work force. You rarely find that in the States. You find tremendous turnover, even at the top. And so you don't get that continuity that you do in a well-run Federal regulatory body.

Ms. ESHOO. Thank you very much. I see that the yellow light is on, and so I will yield back. Thank you.

Mr. OXLEY. The gentleman yields back. The gentlelady from Oregon.

Ms. FURSE. Thank you, Mr. Chairman.

I just would like to ask Ms. LaRoche, it is very good to see you here again, and ask you a couple of questions. At our last hearing we got a list of institutions introduced who had been victims of a New Era fraud. And they included all sorts of—Salvation Army, the University of Pennsylvania, Cancer Center, many, many institutions. Is it fair to conclude that those charities are examples of at least some of the institutions that would have to fend for themselves in dealing with Wall Street if we eliminate the suitability requirements? And are any of these, given the climate of investment, are they likely to stand a chance?

Ms. LAROCHE. A couple of points. First of all, fraud is unacceptable in any venue. Second, with respect to the New Era Fund, it is not appropriate to cloak what occurred as an event of Wall Street. Third, the boards of directors of these charitable organizations do have a responsibility to their organizations to look out for their interests and to make decisions with respect to how and where their funds should be managed.

As I have indicated earlier today, there are alternatives. Those alternatives include hiring investment advisors. If the resources are not available for that, there is a very large broad mutual fund industry in this country that does provide for portfolio diversification and professional investment advice through these pooled vehicles.

Ms. FURSE. So you think that there is and will be after the passage of H.R. 2131 enough protection and enough sense of responsibility or institutional responsibility to protect those—in other words, you are not concerned that this might throw, more or less, sophisticated investment groups into jeopardy?

Ms. LAROCHE. No, no, I am not. Because first of all, with respect to less sophisticated investors, they can always enter into a contractual agreement with any broker dealer under the terms of this legislation that would allow them to be treated as unsophisticated investors.

Ms. FURSE. Are there occasions where you think the brokers might refuse to sign a contract? Would that be a problem?

Ms. LAROCHE. Well, it would be only a problem insofar as if a broker refuses to sign a contract then one shouldn't do business with them. The broker, quite frankly, can also choose not to sign

a contract because it may be perceived to be—they may perceive that they are being asked to be a guarantor and that is a position in which they do not wish to be. This is a very large competitive marketplace where one can shop for price, brains, security, customer relationship, et cetera. So all parties to this transaction do have a lot of alternatives in front of them.

Ms. FURSE. All right.

Let me think about—I just wanted to go through with it and see now if there is an additional responsibility at the time you sign a contract. Can you foresee of any kind of circumstance where all the brokers might say, well, we are never going to sign contracts because we don't want to take on this additional responsibility?

I don't know the market well enough to—I mean, I am really genuinely wanting to know whether you think that could become a great problem.

Ms. LAROCHE. Well, first of all, managing more than $10 million, as I said before, is really not a responsibility that should be taken lightly. So I go back to my reference to the laws and responsibilities of the boards of directors of these institutions or other investors.

Second, with respect to an issue of signing contracts, I mean, that will, depending upon how it all works, it could create market inefficiencies but, quite frankly, a broker/dealer, nor an investor, is bound to do transactions with one or another. There are a lot of other places where they can get their business transacted. It is a free and open market in that respect.

Ms. FURSE. Thank you.

Thank you, Mr. Chairman.

Mr. OXLEY. The gentlelady's time has expired.

Mr. Friedman, your testimony on suitability appears to take two different directions. On the one hand, you note that you are unenthusiastic about the approach in H.R. 2131, which is based on the notion that sophisticated parties should be responsible for their own decisions.

On the other hand, at page 7, in your prepared remarks, you note that you see, quote—you see no reason why a securities firm dealing in good faith with an institutional client should bear the burdens of loss of investments by the client.

Are you prepared to endorse the notion that brokers and institutional investors are competent, sophisticated parties who are in arm's-length relationships?

And, if so, I'm wondering whether the institutional investor should then bear the burdens of its investment decisions as set out by the legislation.

Mr. FRIEDMAN. Well, I certainly, as my testimony indicates, endorse the objectives of Section 2. I think the language in saying there is no liability is too broad because it sweeps well beyond the suitability notion. I think the notion of suitability, which is an idea that the broker has an affirmative obligation to decide what is good for the client, has no application to institutional investors. There are a whole variety of other aspects of the relationship that have to do with disclosure and forthrightness on the part of the dealer that remain very important, and remain a potential source of liability for the broker. So that I think institutions are able to take care

of themselves as long as they are told the truth, and in the case of new products, so long as the dealer or the creator of the product has exercised reasonable care in testing the perimeters of the product.

As I said in my testimony, most people get into trouble in this area because market conditions develop that are beyond the assumptions when the product is developed. So the product performs either in a perverse way or in a leveraged way.

Mr. OXLEY. Ms. LaRoche, do you have a comment?

Ms. LAROCHE. Yes.

Let's remember with respect to suitability, this does not imply that securities dealers are without responsibility in dealing with institutional investors. As dealers, we are appropriately bound to legal and ethical standards in facilitating transactions. We must be honest and we must deal in good faith. We must not mislead our customers. Our calculations must be accurate.

We must employ in these assumptions, good—we must employ good-faith assumptions and, of course, we as broker/dealers are liable for fraud. However, once these responsibilities have been met, a dealer should be able to rely on the certainty that once a security is sold, the financial risk shifts to the buyer. That's a point that I think needs to be underscored.

Mr. FRIEDMAN. I agree with that statement.

Mr. OXLEY. Does anyone disagree with that statement on the panel?

Good. Thank you.

We thank all of the panel for their attendance today, and this panel is dismissed.

[Brief recess.]

Mr. OXLEY. The hearing will reconvene.

I would like to welcome our second panel. The first panelist is Professor Mark Sargent from the University of Maryland School of Law. The second panelist is Professor Rutheford B. Campbell, Jr., the University of Kentucky College of Law. Our third panelist is Mr. Morey McDaniel from Danbury, Connecticut. And our final panelist is Mr. Bradley Belt, Director of Capital Markets and Domestic Policy Issues for the Center for Strategic and International Studies. I don't know how you get all of that on your door.

We will begin with Professor Sargent.

STATEMENTS OF PROFESSOR MARK A. SARGENT, UNIVERSITY OF MARYLAND SCHOOL OF LAW; PROFESSOR RUTHEFORD B. CAMPBELL, JR., UNIVERSITY OF KENTUCKY COLLEGE OF LAW; MOREY McDANIEL, ATTORNEY; AND BRADLEY D. BELT, DIRECTOR OF CAPITAL MARKETS AND DOMESTIC POLICY ISSUES, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

Mr. SARGENT. Thank you, Mr. Chairman.

I would like to start, first of all, by thanking Congressman Markey for raising the question of the marketplace exemption as a way of clarifying what we are talking about and defining the area of dispute. And I am going to try and confine my observations to that area where there is real dispute and to be as specific as possible rather than to be things that you have talked about before.

I must say, however, that with respect to the marketplace exemption, while it is a huge improvement and as someone who spent a lot of time in the 1980's trying to help that improvement come about, the question does not remain—has not become trivial.

First of all, investment companies do not have the benefit of marketplace exemptions. That remains a large regulatory problem.

There is also the risk, as Mr. Krongard suggested, of States opting out from the application of marketplace exemption. There is the risk of add-ons, of additional requirements on to the marketplace exemption. And that category of issuers that are, indeed, subject to the full panoply of State registration requirements is not trivial and they are not all crooks. And there are important public policy issues with respect to the application of State registration requirements to them.

And I should also add that there are major issues with respect to the State regulatory regime for exempt offerings which have not been touched on at all here today and that I will mention. I would like to proceed very simply.

I would like to start off by assuming, for the sake of argument, that State registration requirements generate benefits. I am going to come back and try to raise questions about that assumption, but for now, let's assume that State registration requirements generate benefits for investors.

Before we assume that we have achieved nirvana, we must remember that benefits are achieved by generating costs. You have heard about a lot of those costs and I am not going to go over them in painful detail, but I am going to list them quickly. Start with the simplest, filing fees.

Filing fees seem trivial unless you are an investment company when there is no cap on the filing fee, and you could be spending hundreds of thousands of dollars a year in filing fees in a handful of States.

What about paper, the production of paper? That is also not trivial, particularly with respect to investment companies who have ongoing reporting requirements that generate mountains of costly paper.

Let's get on to more, even more substantial things. You have the costs associated with uncertainty. Can an offering comply with merit requirements, with the substantive fairness requirements that many States apply? I will get back to that.

Can the State—can you comply with State disclosure requirements that are hardly consistent with each other, hardly consistent with the SEC, and often idiosyncratic and the uncertainty associated with the ongoing compliance burden of investment companies can barely be imagined. There are also the costs associated with delay, with offerings being held up to comply with State registration requirements.

There is also the costs for innovation, new forms of business organization, new forms of offering, have to go through what's usually called the Blue Sky Waltz, the process of convincing commissioner by commissioner that the end of the Western world is not near because high-tech issuers, for example, have high dilution and lots of options which have been issued to the insiders because that is the only form of compensation they could afford.

All of these uncertainty costs, delay costs, costs of invention generate legal costs, which is great for lawyers but nobody else. They also create the risk of exclusion of seekers of capital from capital markets, and the bitter irony of all of this is the phenomenon that I call "good guys pay," which is by and large the really bad guys don't even bother with State registration requirements. It is the people who want to do things right, who go through the full panoply of the registration process and pay enormous amounts of money.

Now, if the benefits were great enough we could justify these costs. There is no question about it. But let's ask ourselves whether the benefits generated by State securities registration requirements are really all that substantial.

First of all, there is a big assumption about effectiveness. How do we know that compliance with State registration requirements is effective?

There are many offerings that have gone through a State registration process, but the promoters were determined to engage in market manipulation and they did anyway, and the fact that the offering was registered really didn't prevent that.

Second, the so-called merit provisions or fairness provisions are of dubious benefit to investors. They run the gamut from being so vague and informal as to be arbitrary, to being so minutely detailed that they constitute a straightjacket.

There is enormous academic dispute about the efficacy of merit requirements. I think the best that we can say for merit requirements is that the case is not proven as far as investment benefit. Much of State disclosure regulation is frivolous, meaningless variation from State to State.

The three front page phenomena where you have to have three front pages to accommodate everything that the States believe should be, the individual States believe, should be on the front page, is a benefit to investors from State investment company regulation?

Well, the duplicativeness there has been addressed elsewhere, so I won't go on. Well, I am going to move rapidly.

The arguments in favor of State registration requirements are two:

First of all, that they need a registration filed in order to be effective in the enforcement area, because they can assert a registration violation instead of proving fraud or abuse of trust—philosophical question as to what makes sense.

The second point about that is that if they really need to be able to show a registration violation, I wouldn't have a problem with a notice filing requirement which could be the basis for a registration violation so long as they didn't do any real regulation of the offerings.

More important, however, is this notion that the State registration requirements apply to the smaller riskier SEC-registered offerings that are not—don't have the benefit of the exchange listed or the marketplace exemptions.

Big problems, I think, with this argument. First of all, you have got a disproportion. You have got a certain small sector of offerings that gets hammered by a very significant regulatory scheme, while

offerings that are really not all that different are entirely exempted from it, whether they have an exchange listed exemption or whether they are a big private placement.

I associate myself very much with Mr. Friedman's comments that what we need is a study showing that there is a sector of offerings that needs the extra hand that the State can apply. So I would very much encourage the States and the SEC to work carefully together to define that field in which regulatory responsibilities can be allocated to the States, and we can by no means assume that a rational allocation exists at this point.

My belief, just to wrap up, is that the key to the State's function is enforcement of the antifraud provisions and regulation of securities professionals. That is where the States have proven most effective over the years and that is where they can continue to be effective.

[The prepared statement of Mark A. Sargent follows:]

PREPARED STATEMENT OF MARK A. SARGENT, UNIVERSITY OF MARYLAND SCHOOL OF LAW

I. THE REGISTRATION REQUIREMENTS OF THE STATE SECURITIES LAWS ADD COSTS TO THE CAPITAL FORMATION PROCESS

The costs generated by the generated by the registration requirements of the state securities law need to be evaluated from four perspectives: the costs of state merit regulation, state disclosure regulation, the impact of the state registration requirement on international transactions, and the costs of state regulation of investment companies.

A. The Costs of Merit Regulation

There are substantial direct compliance costs associated with merit regulation. Some of these costs, of course, are not peculiar to merit regulation but result from having to register with both the SEC and the states. Examples of such costs are filing fees, printing costs, some attorneys' fees, and some accounting fees. These costs would be incurred even if all states were to shift to disclosure review. Other compliance costs, however, are directly attributable to merit regulation. Among those costs are the attorneys' fees incurred when the issuer or the underwriter has to negotiate with merit administrators to clear an offering in one or more states. These costs can increase when the offering is controversial and negotiations are prolonged.

Equally significant are the costly delays sometimes generated by difficulties with merit review. These delays can take different forms. Merit difficulties in key states can sometimes cause a national offering to be postponed, even after SEC registration has been effected. A merit problem in a smaller state may simply delay the offering in that state, since counsel may withdraw the registration by coordination and file a registration by qualification, which would give more time to resolve the problem. These delays are perhaps most likely to occur when a new securities product is about to come to market. In short, merit regulation can produce costs through producing delays.

B. The Costs of Disclosure Regulations

The practical problem with state disclosure regulation is a consequence of the stresses inherent in an overlapping state-federal regulatory system. In a national or multistate public offering there is invariably a single prospectus, drafted largely if not entirely in accordance with the SEC's specific disclosure rules and with a vivid awareness of potential liability under section 11 of the 1933 Act. Drafting the prospectus is ordinarily a team effort, requiring significant contributions from issuer's and underwriter's counsel, accountants and other experts, and issuer management, all of whom approach the task with a desire to establish their own due diligence while producing a document that will survive an SEC review. The result is a document that has been thoroughly negotiated after many weeks of effort and that reflects the parties' considered judgment of which information is material and which is not.

Submission of this document to the SEC in the case of IPOs usually results in some revision and amendment. This can create delays and additional expense, but

the process has been institutionalized through a process in which problems are resolved through negotiation. Revision of the prospectus to reflect the concerns expressed in the single federal review process thus is workable so long as the process is administered on the basis of nonarbitrary standards and requirements. Difficulties arise, however, when that single document is subjected to multiple disclosure reviews in multiple jurisdictions. By their very nature, multiple disclosure reviews can make the registration process more difficult and expensive.

In order to satisfy the differing requirements of several state examiners, this carefully balanced disclosure document may have to be partially rewritten or festooned with single-state "stickers," each setting out the different language required to be delivered to investors in individual states. In some cases, furthermore, the disclosures required by an individual state may be regarded as so burdensome that the application for registration will be voluntarily withdrawn, with the result that the underwriter will not offer the securities in that state.

These problems cannot be described as deal-killers. There is no evidence that enforcement of state affirmative disclosure obligations causes entire national offerings to collapse, even though they may cause offerings to be withdrawn from individual states. Furthermore, the tinkering with the language of the prospectus probably will not produce additional exposure to section 11 liability, so long as counsel is careful to fit the state-mandated disclosures in to the overall context of the document. What state disclosure regulation does produce, however, is additional compliance costs, usually in the form of legal fees and printing fees, and, in serious cases, costs of delay. In a more fundamental sense, the necessity to comply with state disclosure requirements generates opportunity costs for all of those involved in the process, including counsel, issuer management, accountants, and others, whose time and resources could be used more productively. Of course, the costs associated with compliance with state disclosure requirements cannot really be disentangled from those incurred in connection with a merit review, but state disclosure regulation can nevertheless be described as a complicating and cost-generating factor of doubtful benefit to investors.

C. The Problem of Securities Internationalization

Former SEC Chairman Richard Breeden suggested that the states should be out of the international regulatory game, except perhaps for purposes of enforcement. He argued that if the United States financial markets are to remain healthy in the face of European and Japanese competition, the fragmentation created by the state securities laws "may need to be re-evaluated" and that there should be a single United States market without "internal barriers that reduce liquidity and increase costs without compelling justification." Breeden later amplified this position by pointing out that "[i]t is frustrating that as of 1991 Great Britain will allow the use of a prospectus filed in Berlin, but it will still not be legal to use automatically a prospectus filed with the SEC in California."

Breeden's ominous words, however, did not generate any serious congressional or rulemaking initiatives intended to force the states out of the international regulatory framework. The state regulators traditionally have resisted any suggestion that they should bow off the international state. They responded to Breeden by reiterating their position that the states should be able to apply both their disclosure and merit standards to offerings by foreign issuers, and supported their position by producing their own study of "international investment fraud and abuse" to demonstrate the need for a strong state regulatory presence in the international markets.

The states' insistence on a place at the international regulatory table, however, will not make them a major force in the regulation of the global securities market. They are already mostly irrelevant in that context. Large offerings by major international issuers will be wholly exempted form blue sky registration by virtue of marketplace exemptions. Similarly, many private placements by foreign issuers are made exclusively to institutional investors and easily qualify for state exemption. The state impact on such offerings is minimal. Furthermore, state involvement in another important aspect of securities internationalization, linkages among exchanges, is likely to be almost nonexistent because the states largely do not regulate the U.S. exchanges. State regulation of securities professionals is also likely to have little international significance until foreign brokerage firms develop retail markets in this country. State participation in international securities regulation is likely to be limited to sharing in multinational enforcement with respect to foreign-based scams in unconventional securities and to disclosure or merit regulation of the small number of offerings by international issuers not listed on the exchanges or the NASDAQ/NMS.

When not irrelevant, state registrations requirements simply create unnecessary costs. As truly international markets and regulatory systems develop, the regulatory aspect of blue sky law, on a very basic level, will seem more and more like an historical anomaly that has outlived its usefulness.

II. STATE ANTI-FRAUD ENFORCEMENT

A serious securities fraud problem exists today, and the blue sky laws are well-suited to deal with it.

The fraud problem relevant to this discussion is not principally that of insider trading in the public markets or of public issuers failing to meet affirmative disclosure obligations. Those problems are addressed by the SEC and extensive use of statutory private remedies. It is also not principally a matter of misrepresentation or deceit in face-to-face securities transactions among business people involved in small business capital formation. Those problems are handled through informal dispute resolution or private litigation. The fraud problem relevant here involves a different type of interchange between individual investors and sellers or securities.

This interchange usually takes place in markets where little intermediation exists and where informational asymmetries abound. Investment decisions in these markets are not made rationally on the basis of portfolio theory. The participants in this interchange include many middle-class and lower middle-class investors with relatively large amounts of disposable income. They have an appetite for unconventional investment opportunities because the economic conditions and tax policies of the past two decades eroded the traditional pillars of personal financial planning: savings accounts, whole life insurance, the thirty-year fixed rate mortgage, and a few stocks and bonds. These investors need to make more complex choices about what to do with their money. They are faced with a bewildering array of opportunities. The veritable explosion of choices theoretically facilitates the more efficient allocation of investment capital, but it also presents substantial opportunities for defrauding those who are unsophisticated, unfamiliar with the advantages of portfolio investment, eager for above-market returns, acting without sophisticated advice, and subject to direct manipulation by unscrupulous promoters.

The available evidence shows that those opportunities have not been ignored. The evidence suggests that well-organized groups of securities law violators are using modern communications technology in a massive exploitation of unsophisticated investors. Promoters of a vast variety of telemarketing scams have similarly used banks of telephones in packed "boiler rooms" to generate hundreds of "cold calls" a day to potential victims. Using such technology to cross state lines and extend their reach regionally and nationally, these operators push a constantly changing array of investment opportunities, usually in the form of investment contracts. While generating an exact dollar figure is impossible, it is fair to assume that a truly staggering amount of money has been lost by people who cannot afford such losses into a host of other unconventional or exotic securities offerings. These scams exploit every possible marketing edge. "Affinity scams" abound: fraudulent transactions that use religious, ethnic or political affiliations among promoters and investors to generate a sense of trust that can be manipulated into an investment decision.

In short, ample evidence indicates that there is a fraud problem today. Nothing suggests, furthermore, that the problem is likely to abate any time soon. The ultimate question, therefore, is whether blue sky law is well-adapted to address it. The answer to that question requires a few cautionary distinctions.

First, blue sky law cannot deal with the problem alone. It is a problem of national and increasingly international dimensions. It requires a federal and SRO response, as well as a state response. The current sharing of enforcement responsibilities, which involves substantial federal-state-SRO cooperation, already embodies an appropriately joint effort.

Blue sky enforcement can continue to function effectively in the prosecution of localized and regionalized fraud only within such a framework.

Second, only certain aspects of blue sky law are suited to combating the fraud problem. Today's blue sky law is still grossly overinclusive. Its merit provisions still attempt to do much more than prevent or remedy fraud. The state administrators' attempts to superimpose disclosure obligations upon national public offerings in addition to those imposed by the SEC are largely duplicative and, when not, unnecessary. Those types of regulation, furthermore, do not address the real problem. The securities law violators who most need to be controlled are utterly indifferent to the niceties of either state or federal registration requirements and are untouched by government-mandated disclosure requirements. They are hardly sensitive to state merit criteria. They are simply concerned with using fraudulent devices to separate

investors from their money as quickly as possible. They fly below the registration radar screen. The most effective government response is civil and criminal prosecution of fraud in connection with securities offerings and the behavior of securities professionals. This is true even with respect to registered penny stock offerings, whose abuses are most effectively controlled by stringent disclosure requirements, close regulation of marketing techniques, vigorous prosection of market manipulation and other types of fraud, and exclusion of proven bad actors from the securities industry. Such measures target specific abuses without being overinclusive or diverted by largely irrelevant questions of fairness.

Third, the resources of state securities administrators need to be shifted toward enforcement and away from unneeded regulatory efforts that undermine the credibility and effectiveness of state securities regulation. As part of this shift, links between prosecution of securities fraud and other types of financial fraud should be drawn more tightly. There should be institutional linkages among offices fighting securities fraud, those attacking quasi-securities scams in the franchise and business opportunity areas, and those involved in other types of financial consumer fraud.

With those cautionary distinctions in mind, one may conclude that blue sky law is well-suited to addressing the real problem of securities fraud. The presence of enforcement personnel in the states, which provides a relatively high degree of accessibility to defrauded investors, also allows the blue sky administrators to serve as a tripwire alerting the SEC, the SROs, and law enforcement agencies to the growth and spread of individual or particular types of scams. The states' local nature allows them to be the first on the scene and to lay the foundation for further enforcement action by other agencies. The culture of the enforcement divisions of blue sky offices is also right for the task.

In sum, the blue sky laws should continue to provide a basis for state participation in a multi-level approach to the pervasive problem of securities fraud.

Mr. OXLEY. Thank you.

Professor Campbell.

STATEMENT OF PROFESSOR RUTHEFORD B. CAMPBELL, JR.

Mr. CAMPBELL. Thank you.

The reason I am here, I suppose, is that about 10 years ago, I wrote a piece in a law journal entitled, "The Nonsense of"—"An Open Attack of the Nonsense of the Blue Sky Regulation." The title aptly caught my sentiment in those days and it is unchanged at this point.

I have been a critic of these laws over a substantial period of time. Thus, I support preemption of the—certain of the—certainly the registration and the merit provisions that are a part of this act. I, like most of everyone before me, firmly believe that the States do have an ongoing role in the future, but I think that role should be limited and should be limited quite strongly to enforcement of antifraud provisions.

The preemption argument, argument in favor of preemption, I believe, transcends political and economic bounds. People—there are two ways to favor preemption: One is that ever-classical economist point of view, that all regulation is bad. This is a regulation. Therefore, it has got to be bad. That is not my view, notwithstanding the fact that I teach a course on law and economics.

My view is that some regulation is good. And unlike the law and economics guys, I tend to be able to find more market failures and other values that are worth promoting. And so I come at this not from the point of the view of the economist who says all regulation is bad, but rather from the point of view of trying to fashion regulation that is, in my terms at least, efficient.

With regard to the registration provisions of the State level, I disagree, I think, a bit with my good friend Professor Sargent, al-

though I think we don't disagree all that much. I find the costs of complying with the registration at the State levels to be significant and I find absolutely no benefit from having people do the same thing 52 times—it has always been quite curious to me.

With regard to the costs, there are, of course, there are the costs that the economists would raise, such as the costs of running blue sky departments and arguments that monies ought to be spent in other ways. But really, the kinds of costs that I saw and probably the kinds that prompted my piece years ago, were the costs that I saw in putting deals together in the trenches out there. And what happens, of course, is that you do have to do the same thing 52 times or, in some instances, maybe only 10 or 12.

And this is one prospective, maybe I can bring to the panel, and to you all, and that is, these registration provisions and the costs of these impact disproportionately on small issuers. What kills deals and throttles capital formation among small issuers is not the absolute cost of putting a deal together, but rather the relative cost; that is, costs of a function of how much you generate from the actual offering. These have always fallen and will continue to fall, I think, unfairly on small issuers. That problem is exacerbated significantly by blue sky laws.

I think that the real beneficiaries of this, if, in fact, there is preemption, will to a large extent be the small issuers, who otherwise are going to be facing very high relative costs to tap into the capital market.

With regard to any benefits of the registration, I find zero. And the reason I find zero is because of this: There simply are out there other pressures that take care of the need for adequate disclosure. The Federal mandatory provisions for disclosure are there and often overlooked, but it should not be overlooked, are the antifraud provisions in the Federal Act.

If you repeal the entire 1933 Act, there would still be mandatory disclosure and that would come from Section 10(b) and Rule 10(b)(5) which requires always that there be disclosure of all material facts. If, in fact, you repeal the blue sky laws, not only do you have the Federal registration provisions left, but you also have the mandatory provisions of the antifraud provisions in 10(b) and 10(b)(5).

Finally, I think out there are the market forces, which I think have a certain amount of therapeutic value, although as one who is not entirely comfortable with the law and economics movement, I think that some supplemental regulation is necessary.

In the area of merit regulation, again, I argue against merit regulation on the same—for the same reason I argue against duplicative registration, and that is on any kind of cost/benefit analysis it is impossible for me to make any sense out of merit regulation. As a philosophical matter, of course, it is a completely different system than a Federal disclosure and it, in fact, is consumer protection, where State regulators are supposed to sit down and read a prospectus, read a registration statement and determine whether or not they will permit citizens in their State to invest in that particular security.

When you consider that that is heaped on top of both State and Federal antifraud provisions and State registration, State and Fed-

eral registration provisions, then we have a system of regulation that, in my judgment, is enormous overkill. It is my opinion that the citizens should not be asked to pay for some bureaucrat to at some State to sit and go over a registration statement and then determine that, in fact, the citizens of that State should not be permitted to invest in it, assuming, of course, that there is full disclosure. Because those provisions are always there.

The other related point I would make is: I am very uncomfortable in regulation in having State bureaucrats, and I do not mean that in a pejorative sense at all, and it should not be interpreted as such, but I have a great deal of trouble of having State bureaucrats or any bureaucrats to control the capital flow—the flow of capital into the markets. I think the markets should make those kind of decisions rather than State bureaucrats or any bureaucrats.

Thank you.

[The prepared statement of Rutherford B. Campbell, Jr. follows:]

PREPARED STATEMENT OF RUTHEFORD B CAMPBELL, JR., UNIVERSITY OF KENTUCKY COLLEGE OF LAW

My name is Rutheford B Campbell, Jr. I am a Professor in the College of Law at the University of Kentucky, where I teach courses in Business Associations, Securities Regulation, Corporate Finance, and Law and Economics. From 1988-93, I was Dean of the College of Law.

My writings, a partial list of which is attached, have been primarily in the corporate and securities areas, and a number of my writings have been specifically concerned with the impact of state and federal securities laws on the capital formation process.

During 1969 and 1970, I was an associate in the New York law firm of White & Case. From approximately 1978 to date, I have been Of Counsel to the Lexington, Kentucky law firm of Stoll, Keenon & Park. I left legal education from 1980-82 to be a partner in Stoll, Keenon & Park. My practice both at White & Case and at Stoll, Keenon & Park was in the corporate and securities areas. In my practice, I provided (and continue, at least to some extent in my "Of Counsel" position with Stoll, Keenon & Park, to provide) legal advice regarding registered and exempt securities offerings.

A STATEMENT OF PHILOSOPHY

My philosophy regarding securities regulation, as reflected in my writings, is not that of the neoclassical economist who argues that securities should be entirely unregulated as a way to achieve economic efficiency. While I believe in the value of economic efficiency, my view is that market failures and a legitimate concern for values other than economic efficiency, such as the value of minimizing individual losers, makes some regulation of the securities markets appropriate, even if the result is some loss in economic efficiency.

I am not, therefore, one who argues that state regulation of securities is bad because all regulation of securities is bad. Instead, I argue that state regulation of securities is bad because such regulation is costly to society and adds nothing to legitimate protection of investors.

SOURCES FOR REMARKS AND EVALUATION

The following remarks on Section 3 of H.R. 2131, the Capital Markets Deregulation and Liberalization Act of 1995 (the "Legislation"), are an adaptation in large part of an article of mine, *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 *The Journal of Corporation Law* 553 (1985) (Hereinafter "*Open Attack*"). I have taken the liberty of using the text of my article without further citation or quotation marks. In addition, because of the time pressures in preparing my written remarks, I was unable to update all my sources in the accompanying footnotes. Necessarily, therefore, some citations will have changed (e.g., the dates for state laws), references to more recent, important works may be omitted, and certain states may have changed their positions on certain matters. Such recent changes, however, alter none of the views I express and eliminate none of the problems discussed herein to any significant degree.

GENERAL EVALUATION OF TODAY'S BLUE SKY LAWS AND THE LEGISLATION

The evolution of blue sky laws in this country is a classic example of regulation that was, perhaps, initially justified and that was apparently promulgated with the best of motives, but which now is actually harmful to society. Today, blue sky laws are ineffective, philosophically unsound, and unnecessarily expensive, and they should be substantially eliminated.[1] Because of the vested interests that have developed,[2] however, it is unlikely that states will respond to this problem, and it will probably take action by the United States Congress to preempt the area. Such an action is appropriate and, indeed, is long overdue.

The case for substantially eliminating state blue sky laws is based, fundamentally, on a cost-benefit analysis. This writer's research in connection with his Open Attack article uncovered no meaningful benefit to society from state regulation of securities. In the area of mandated registration of securities offerings, for example, blue sky laws merely duplicate the federal requirements and as a result add no additional protection for investors. Where merit regulation is concerned, however, the regulatory scheme is harmful to society, even without considering the actual dollar costs of such regulation. Although in his *Open Attack* article, the writer attempted no precise quantification of these dollar costs to society, that article contained some information and observations about the level of expenditures generated by the enforcement of and compliance with state blue sky laws. The inference from that information leads to the conclusion that blue sky laws exact a considerable tribute from society.

PURPOSES OF BLUE SKY LAWS; SCOPE OF THE LEGISLATION

Blue sky laws traditionally operate in four areas. First, blue sky laws require an issuer of securities either to register those securities[3] with the particular state division or to qualify for an exemption from registration.[4] Second, blue sky laws impose certain standards as a prerequisite to the right of an issuer to sell securities to the public.[5] The application of these standards by a state is referred to as "merit regulation." Third, blue sky laws require registration and licensing of persons and firms performing broker-like[6] functions within the particular state.[7] Fourth, blue sky laws provide remedies for fraud in connection with securities transactions.[8]

As proposed, the Legislation substantially preempts the first and second areas (i.e., registration and merit regulation), described above, while leaving the third area (broker-dealer regulation) somewhat subject to state laws and regulation. The fourth area (antifraud matters) is essentially unchanged from its present situation.

BLUE SKY REGISTRATION REQUIREMENTS AND MERIT REGULATION

Blue sky laws require that securities offered or sold in a particular state either be registered with that state's division or be exempt from the registration require-

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[1] The writer would not argue all state securities divisions should necessarily be eliminated. If states wish to invest resources in this area, however, they should be limited to the enforcement of federal antifraud standards. Any legislation in the area should provide states with this option. *See infra* text accompanying note 151.

[2] The vested interests in this case are those of the bureaucrats who are employed by the various state securities divisions. It would, of course, be quite surprising if they were unwilling to fight for the status quo. Some have already defended their functions. *See, e.g., Goodkind, Blue Sky Law: Is There Merit in the Merit Requirement?*, 1976 WIS. L. REV. 79, 123 (defense of merit regulation by a state regulator).

[3] *See, e.g.*, UNIF. SECURITIES ACT §§301-304, 7A U.L.A. 596-612 (1958). Since the Uniform Securities Act has been adopted in a majority of states, references to state blue sky laws will generally be made to that Act unless deviations by states are relevant for this paper.

[4] There are various exemptions from the registration provisions of blue sky laws. Some involve exempt transactions, while others involve exempt securities. UNIF. SECURITIES ACT §402(a), 7A U.L.A. 638-40 (1958) (exempts certain securities); UNIF. SECURITIES ACT §402(b), 7A U.L.A. 640-42 (1958) (exempts certain transactions).

[5] For a good discussion of the various merit standards in the states, see Goodkind, *supra note* 2, at 87-107.

[6] In addition to "broker-dealers" and "agents," "investment advisors" must register in most states. UNIF. SECURITIES ACT §201, 7A U.L.A. 576 (1958).

[7] One issue that will not be treated in this paper is the extraterritorial application of a particular blue sky law. On the subject, see Friedman, *Searching for a Blue Sky Remedy—A Forum Shopper's Guide*, 15 WAYNE L. REV. 1495 (1969).

[8] UNIF. SECURITIES ACT §101, 7A U.L.A. 568 (1958).

ments.[9] Although this is the same basic rule as the Securities Act of 1933 ("1933 Act"),[10] there are some significant differences between state and federal registration and exemption requirements. For example, the exemptions from state registration differ from federal exemptions.[11] More significantly, however, the very purpose for the state registration requirements apparently differs from the purpose of the registration requirements under federal law.

Under federal law, the purpose of registration is disclosure. As a result, Section 5 of the 1933 Act requires that a prospectus be delivered to each investor.[12] In order to ensure that the prospectus conforms to the disclosure requirements of the 1933 Act, the registration statement is submitted to the Securities and Exchange Commission (the "SEC") for the staff's review.[13]

The purpose for registration under state blue sky laws differs from the pure disclosure philosophy of the 1933 Act. The Official Comment and the Draftsmen's Commentary to the relevant sections of the Uniform Securities Act make it clear that the primary purpose of the registration requirements is to provide the commissioner with sufficient information to determine whether the offering meets the substantive standards of the Uniform Securities Act.[14] In other words, the primary purpose of state disclosure is to facilitate the application of the merit standards of the particular state.[15]

It follows, therefore, that the Uniform Securities Act does not contain any prospectus delivery requirement. Instead, the registration statement is only submitted to the commissioner, and there is no requirement that the investor receive any information.[16] Section 304(d) does provide, however, that the commissioner may, by rule or order, condition a registration by qualification on the delivery of a prospectus to each offeree,[17] but the Official Comment indicates that such requirement should be limited to "unusual cases."[18] The Official Comment goes on to state: "This Act, unlike the federal statute, is not primarily a disclosure act"[19]

The states, however, have not been content to limit the purpose of registration to the facilitation of merit review. Instead, most states have adopted laws or regulations requiring that a prospectus be delivered to investors in connection with any registered offering.[20] As a result, the registration provisions now require significant disclosure to investors, as well as facilitate the application of the state's merit requirements.

Disclosure Requirements

Certain scholars have questioned whether government should mandate disclosure in connection with the offer and sale of securities. Some have argued that the very premises underlying the disclosure philosophy are questionable.[21] Others have ar-

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[9] *Id.* §301, 7A U.L.A. 596 states: "It is unlawful for any person to offer or sell any security in this state unless (I) it is registered under this act or (2) the security or transaction is exempted under Section 402."

[10] Securities Act of 1933 §3-5, 15 U.S.C. §77(c)-77(e) (1982)).

[11] *Compare* Securities Act of 1933 §3 and 4, 15 U.S.C. §77(c) and (d) (1982) *with* UNIF. SECURITIES ACT §402, 7A U.L.A. 638-42 (1958).

[12] Securities Act of 1933 §5, 15 U.S.C. §77(e) (1982).

[13] Although each registration is required to be submitted to the SEC, the staff no longer reviews each registration. Instead, the staff will review certain registration statements while assuming a "no-review" position in certain cases.

[14] UNIF. SECURITIES ACT §303(a), 7A U.L.A. 606 (1958) (Official Comment and Draftmen's Commentary); UNIF. SECURITIES ACT §304(d), 7A U.L.A. 612 (1958) (Official Comment and Draftmen's Commentary).

The following states have adopted or substantially adopted the Uniform Securities Act: Alabama Alaska, Arkansas, Colorado, Connecticut, Delaware, District of Columbia, Guam, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, Oklahoma, Oregon, Pennsylvania, Puerto Rico, South Carolina, Tennessee, Utah, Virginia, Washington, West Virginia, Wisconsin and Wyoming. I BLUE SKY L. REP. (CCH) ¶5,500, p. 1503.

[15] One author has referred to blue sky laws as "the first consumer protection statutes." Long, *supra* note 7, at 543.

[16] UNIF. SECURITIES ACT §§303-305, 7A U.L.A. 604-20 (1958).

[17] *Id.*, §304(d), 7A U.L.A. 612 (1958).

[18] *Id.*, §304(d), 7A U.L.A. 612 (1958) (Official Comment).

[19] *Id.*, §7A U.L.A. 612 (1958).

[20] See, e.g.: ALA. CODE §8-6-7(c) (1984); ALA. SEC. COMM'R, Rul. 6-4-2; ARK. STAT. ANN. §67-1244(d) (1980); Sec. Comm'r Rul. §10.2. CONN. GEN. STAT. §36-487(d) (1983); CONN. AGENCIES REGS. §36-500-18(d) (1979); DEL. CODE ANN. §7306(d) (1974); IDAHO CODE §30-1426 (1980); KY. REV. STAT. § 292.380(1) (1981).

[21] H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF PURPOSE (1979). Professor Kripke concludes:

gued that decisions about the level of disclosure that companies make should be market decisions and not governmental decisions.[22] These latter critics contend that market pressures would force disclosure of sufficient information at a much cheaper cost to society.[23]

As stated in Section B, above, this writer is convinced of the appropriateness of some regulation of securities and thus does not base his criticism of blue sky on any claim that all mandated disclosure is bad. Instead, this writer's criticism of blue sky disclosure requirements is based on the fact that the mandatory federal disclosure requirements are entirely sufficient to protect investors at an appropriate level, and thus no benefit for investors is generated by the imposition of additional registration requirements at the state level. The mandatory disclosure requirements of state blue sky laws, therefore, are inefficient, wasteful and retard unnecessarily capital formation.

If an issuer is required to file a registration statement under the 1933 Act, the prospectus delivery requirements under the 1933 Act necessitate the disclosure of a substantial amount of information to each investor. This required information includes balance sheets and income statements, usually audited and usually for a period of years, information about management, information about the industry and the company, information about the terms of the underwriting and many other pieces of information concerning the company and related matters.[24]

These requirements regarding what information must be disclosed in a federal registration statement and prospectus are the result of a long evolutionary process. This evolution has involved input from a number of talented, perceptive and experienced groups, including the SEC and its staff, the securities bar and the academic community.[25] Accordingly, both the amount and type of information required by federal regulations are sufficient to protect investors.

In addition, one cannot ignore the time and effort that go into completing a federal registration statement. Many hours of professional time are required to complete a registration statement.[26] Also, the officers and employees of a company will spend many hours gathering and disclosing the information required in a registration statement. Finally, if the issue is underwritten, the underwriter and its counsel

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The disclosure system was founded, without investigation or serious consideration,on erroneous premises, namely, that the written SEC documents would be the primary, if not the only source, of investor information, that they would be used and understood by lay investors and that they would be sufficient and adequate for the purpose.

The Commission has shown no creative ability to overcome these erroneous premises with a fresh start. It has been content to trumpet the virtues of disclosure, while showing no disposition (except the appointment of the Advisory Committee) to learn how disclosure is in fact used for securities decisions, and it has shown no creative interest in how it could best be used.

The Advisory Committee did several things of admitted utility, including the final shove to move the Commission toward projections. But in my opinion, its only recommendation for a break with the past was in urging the Commissioner to emphasize disclosures showing the amounts, timing, and certainty of cash flows. In this thinking, it had been preceded by the FASB.

Now we know that:

—Securities selection is a process of choice among alternatives, and the disclosure document on a single company does not provide all the information necessary for choice.

—Securities decisions are too complicated for laymen.

—Securities decisions are made by professionals who use broader information sets than those provided by SEC documents, including (I) better indications of improvement of wealth than those furnished by present-day accounting; (2) projections and other forward looking information, on which Commission policy is still tentative; (3) industry wide information.

The SEC documents are usually filed after the information is otherwise available.

The efficient market hypothesis raises a basic question whether efforts to use financial information to select individual securities can yield results superior to those obtained by buying and holding a diversified portfolio. On the practical plane astute investors are giving credence to the efficient market theories by moving toward diversification and placing the emphasis on selection of portfolios, not individual securities.

Id. at 284-85.

[22] *See, e.g.*, R. POSNER, ECONOMIC ANALYSIS OF LAW 332 (2d ed. 1977).

[23] *Id.*

[24] *See, e.g.*, Form S-l adopted by the Securities and Exchange Commission for the registration of securities, 2 FED. SEC. L. REP. (CCH) ¶¶ 7121-7126 (Mar. 7, 1984).

[25] Prior to the adoption of any rule change, the SEC proposes the particular new rule and requests public comment. Often, depending of course on the particular rule involved, the SEC receives numerous comments from the securities bar and others.

[26] The time necessary to complete a registration statement can vary substantially. One important factor, of course, is the registration form that the issuer is required to use. Some of the new forms, such as Form S-3, can reduce substantially the cost and time necessary to complete the registration process. *See*, 2 FED. SEC. L. REP. (CCH) ¶¶ 7151- 7155 (May 23, 1984) (the text of Form S-3).

will spend a significant number of hours investigating the company and editing the registration statement.

While one may concede the adequacy of federal disclosure requirements when a federal registration statement is mandated, the adequacy of disclosure in offerings exempt from federal registration requirements may be less clear. Even in those situations, however, federal law requires the issuer to make significant disclosures about the company and the offering, and accordingly, additional state requirements are unnecessary.

The 1933 Act contains at least six exemptions that have general applicability to the sale of stock by issuers. These exemptions include the intrastate exemption under Rule 147,[27] three exemptions contained in Regulation D, which are Rule 504,[28] Rule 505[29] and Rule 506,[30] and the exemption for nonpublic offerings in Section 4(2).[31] Finally, there is the exemption contained in Section 4(6),[32] the newest statutory exemption of general applicability.[33]

Whichever of these exemptions is used, federal law requires that the issuer disclose information about the deal to the purchasers of the securities. Sometimes this disclosure is a prerequisite to the availability of the exemption, such as is the usual case in Rule 505, Rule 506, and, probably, Section 4(2). In other instances, such as the intrastate offering, Rule 504 and Section 4(6), disclosure is not a prerequisite for the availability of the exemption, but disclosure is nonetheless necessary in order to avoid a violation of the antifraud provisions under federal law. In all instances, the disclosure requirements are sufficient to protect investors, and no additional protection by the states is necessary.

Under Rule 505, which is part of Regulation D,[34] offers and sales of securities up to an amount of $5,000,000 are exempt from federal registration, provided certain conditions are met.[35] These conditions include a limitation on the number of purchasers,[36] a prohibition against general advertising,[37] limitations on resales and, in most instances, a requirement that prescribed information be furnished to each purchaser of the securities.[38] Normally, the issuer is required to supply each purchaser with the information contained in a designated, Commission approved disclosure form. Rule 506[39] provides for an exemption from registration without imposing any limitation on the dollar amount of securities that can be sold. Two requirements of Rule 506 are most relevant to this discussion. First, each purchaser must be either sophisticated or an "accredited investor."[40] The definition of an accredited investor includes persons who are wealthy and persons who are insiders.[41] Second, disclosure requirements must be met before the exemption can be used. As with Rule 505, qualification of a Rule 506 offering requires the issuer to disclose the same kind of information as would be required on a particular Commission approved disclosure form.[42]

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[27] 17 C.F.R. §230.147 (1984). For an excellent article on rule 147, see Hicks, *Intrastate Offering Under Rule 147,* 72 MICH. L. REV. 463 (1974). There is also the possibility of an exemption from registration pursuant to the common law that has developed under §3(a)(11) of the 1933 Act, 15 U.S.C. §77c(a)(11) (1982). Because of the ambiguities in that exemption, it is rarely used by experienced counsel. *See,* I L. Loss, SECURITIES REGULATION 591-605 (2d ed. 1961).

[28] 17 C.F.R. §230.504 (1984).

[29] 17 C.F.R. §230.505 (1984).

[30] 17 C.F.R. §230.506 (1984).

[31] Securities Act of 1933, §4(2), 15 U.S.C. §77d(2) (1982).

[32] Securities Act of 1933, §4(6), 15 U.S.C. §77d(6) (1982).

[33] There are, of course, other exemption provisions under the 1933 Act. Those exemptions from registration, however, either involve special securities (such as government securities) or special transactions (such as recapitalizations) or are so confining as to be practically unavailable. The latter case is exemplified by the exemption from registration provided by Regulation A under the 1933 Act. 17 C.F.R. §230.251-.264 (1984). For a criticism of Regulation A, see Campbell, *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market,* 1977 DUKE L.J. 1139.

[34] Regulation D consists of 17 C.F.R. §230.501-.506 (1984).

[35] 17 C.F.R. §230.505 (1984).

[36] 17 C.F.R. §230.505(b)(2)(ii) (1984).

[37] 17 C.F.R. §230.502(c) (1984).

[38] 17 C.F.R. §230.505 (1984). No disclosures are required by the rule if sales are made only to accredited investors. 17 C.F.R. §230.502(b)(1)(i) (1984).

[39] 17 C.F.R. §230.506 (1984).

[40] 17 C.F.R. §230.506(b)(2)(ii) (1984).

[41] 17 C.F.R. §230.501(a) (1984).

[42] 17 C.F.R. §230.502(b)(2)(i)(B) (1984). In 1983, the Commission issued an extensive interpretive release on Regulation D. *See,* Interpretive Release on Regulation D, Release No. 33-6455, 48 Fed. Reg. 10,045 (1983). For an exhaustive treatment of Regulation D in outline form see Wertheimer, *Small Issuers: Update on Regulation D,* I FIFTEENTH ANNUAL INSTITUTE ON SECURITIES REGULATION (COURSE HANDBOOK) 377 (1983).

The requirements for the availability of the exemption in Section 4(2)[43] have always been something of a mystery. Today, however, it seems that there is a general consensus with regard to two elements. First, the offerees and purchasers must be sophisticated. Second, each purchaser must be supplied with the same information that would be contained in a registration statement.[44]

The disclosures mandated by Rule 505, Rule 506, and Section 4(2), therefore, are extensive. In addition, the exemptions usually impose additional requirements (such as sophisticated offerees or purchasers) designed to protect investors. In those instances, federal requirements are entirely adequate to protect investors, and it makes no sense for states to impose a separate disclosure scheme on top of the federal plan.

Disclosure is not, however, a prerequisite to the exemptions from registration available under Rule 147, Rule 504, or Section 4(6). The essential requirements for complying with Rule 147 are that the issuer be incorporated and doing business in the same state where the offerees and purchasers reside.[45] For an exemption under Rule 504, the offering cannot exceed $1,000,000.[46] Under Section 4(6), an issuer can sell up to $5,000,000 in securities to accredited investors, provided there is no advertising or general solicitation.[47]

Each of the foregoing exemptions is, however, subject to the antifraud provisions under the 1933 Act and the Securities Exchange Act of 1934 ("1934 Act"), and those sections require that all material facts be disclosed or be available to each purchaser of securities.[48] Thus, disclosure is still required. It is just that disclosure is not a prerequisite to use of the exemption, and there is no particular form that tells one specifically what must be disclosed.

This writer's experience is that most issuers prepare and distribute an offering circular or memorandum in connection with exempt offerings, even in situations where disclosure is not a prerequisite to use of the exemption. Clients with which this writer has been involved over the years have invariably conceded the necessity for such a document, and only in unusual situations have such deals been completed without such an offering circular. Conversations with other members of the securities bar indicate similar experiences by those attorneys.

As to the quality of these documents, this writer has generally found the depth and breadth of such disclosure to be appropriate for the circumstances.[49] At least, these documents appear as adequate as those prepared in situations where disclosure is a prerequisite to the availability of an exemption.

Moreover, the issuer's flexibility to fashion disclosure documents based on a materiality standard is an attractive feature. Excessive disclosure requirements can, of course, throttle capital formation. For example, it would be practically impossible for an issuer selling $50,000 in securities to prepare and disclose the information prescribed by Form S-1. Costs, in light of the size of the offering, would make such disclosures impractical. On the other hand, an issuer selling $10,000,000 in securities probably could afford to pay for the disclosures required by Form S-1. By defining an issuer's disclosure requirements in terms of materiality, an issuer is able to fashion a level of disclosure that is appropriate for the size of the deal. This essential trade-off is necessary,[50] unless we are willing to foreclose small offerings by issuers.

Even if one were convinced that the federal disclosure requirements are inadequate, however, it would still be inappropriate for each state to have its own scheme of disclosure. Inadequacies in disclosure requirements should be remedied

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[43] Securities Act of 1933 §4(2), 15 U.S.C. 77d(2) (1982).

[44] *See, e.g.*, Schwartz, *The Private Offering Exemption—Recent Developments*, 37 OHIO ST. L.J. 1, 17 (1976). For a somewhat different view, see Schneider, *The Statutory Law of Private Placements*, 14 REV. SEC. REG. 869 (1981).

[45] 17 C.F.R. § 230.147 (1984).

[46] 17 C.F.R. §230.504 (1984).

[47] Securities Act of 1933 §4(6), 15 U.S.C. 77d(6) (1982).

[48] The most significant of these fraud provisions for the purposes of this paper are Section 12(2) of the Securities Act of 1933, 15 U.S.C. §77l(2) (1982), and Rule 10b-5 promulgated under the Securities Exchange Act of 1934, 17 C.F.R. §240.10b-5 (1982).

[49] An example of this is probably instructive. The firm in which this author was a partner and with which he is presently of counsel does a significant part of its practice in the horse business. Normally, for horse deals, disclose documents that are based on Form S-1 or S-18 are 60 to 80 pages. The firm has also developed disclosure documents for smaller horse deals where disclosure is not a prerequisite to the availability of an exemption. These disclosure documents are about 20-30 pages.

As an aside, the consensus among the firm members is that the shorter document is actually a better disclosure document for the investor.

[50] This trade-off has been recognized by the Commission in Regulation D, which requires increased levels of disclosure as the size of the deal increases. 17 C.F.R. §230.502(a) (1984).

at the national level, for a number of reasons. In the first place, there is no compelling need for local control in this matter. A company in Idaho should make essentially the same disclosures as a company in Ohio, since investors need the same basic information about companies, no matter where the investor or the company is located.

On the other hand, there is a compelling reason for uniformity in the disclosure requirements. Without such uniformity, any issuer making a wide distribution of securities must comply with the disclosure requirements of many different jurisdictions, each of which may have "different standards, different definitions, different exemptions and different procedures."[51] Although the only way one can truly appreciate the difficulty generated by a multistate offering is to participate in one, even the layman should appreciate the appalling complexity of a broad offering. This complexity, of course, adds to the risk that an issuer will inadvertently violate a state's laws and increases significantly the cost associated with an offering.

Finally, one must recognize differences in resources and quality between the SEC and the divisions of the various states. The point here is not that the staffs of the states are necessarily poor. This writer's experience has been, however, that the quality of the SEC staff is uniformly high, while one does not always get the same impression about the staffs of all states. This may, of course, merely reflect the lack of resources allocated to the states' staffs by the state legislatures. For whatever reason, it seems apparent that the SEC is more capable of developing sensible disclosure norms than are the states. The SEC has the resources, experience and continuity to handle this task.

In summary, therefore, this writer would argue that the disclosure requirements under federal law are sufficient and that it is unnecessary for the states to impose any additional requirements. In the instance of an offering registered under federal law, the prospectus delivery requirements insure disclosure; when the offering is exempt from federal registration, the disclosure requirements of the particular federal exemption or the general antifraud provisions insure sufficient disclosure. Furthermore, to the extent that adjustments are needed in the disclosure standards, these adjustments should be made uniformly by the SEC.

Merit Regulation

From the very inception of modern blue sky laws, certain commentators have stoutly defended merit regulation. In the early 1920's, commissioner Dolley went on record by loudly extolling the success of his application of merit standards in Kansas.[52] More recently, some administrators from the states have written in law reviews attempting to demonstrate the efficacy of merit regulation.[53] This writer is convinced, however, that in today's world merit regulation simply is not worth its cost to society.

Merit regulation generally empowers state securities commissioners to deny registration if the offering does not meet the substantive standards contained in the particular state's securities act.[54] Although the standards applied by the various states involve, as one commentator observed, "a confusing array of substantive tests",[55] the standards typically are designed to ensure the fair treatment of investors by protecting investors from exploitation at the hands of promoters and underwriters.

A major portion of merit regulation, therefore, is designed to ensure that the original owners of the company (i. e., those who own the company prior to the public offering) do not retain an unfairly large portion of the company after the proposed offering is completed. In this regard, a some states will deny registration if the commissioner concludes that stock has previously been purchased by insiders at prices that are unfairly low.[56]

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[51] "The mechanical problems involved in preparing an issue for a nationwide distribution under approximately forty different statutes with different standards, different definitions, different exemptions and different procedures—and somehow synchronizing effectiveness everywhere so that the issue may be offered on the same day throughout the country—are literally appalling." UNIF. SECURITIES ACT §303(a) (1956) (Proposed Final Draft and Commentary, L. Loss & E. Cowett).

[52] L. Loss & E. COWETT, *supra* note 3, at 7-10.

[53] Goodkind, *supra* note 2; Hueni, *supra* note 15.

[54] *See, e.g.*, UNIF. SECURITIES ACT §306, 7A U.L.A. 620 (1958).

[55] Goodkind, *supra* note 2, at 87.

[56] *See, e.g.*, UNIF. SECURITIES ACT §306(a)(2)(F), 7A U.L.A. 621 (1958), which permits the state commissioner to deny registration if he determines that the offering "would be made with unreasonable amounts of... promoters' profits or participation." In a 1976 law review article, one author reported that "[t]hirty-two states have statutory or administrative code provisions per-

Although states have developed various criteria to deal with the acquisition of "cheap stock" by promoters, a typical formula will result in the denial of registration if there is an "unreasonable" amount of cheap stock going to promoters.[57] As one would imagine, states have differing tests for determining whether the prior sale to promoters was "cheap," whether the amount was "unreasonable" and whether the prior issuance was so distant as not to be a problem.[58]

Some states apply merit criteria that focus on the price paid for stock by the new investors and, accordingly, will deny registration in the event the commissioner determines the price to the public is excessive or unfair.[59] This, course, is merely a corollary to the limitation on cheap stock, since both are intended to insure a fair division of the company between the promoters and the new investors. Again, states apply different formulas to determine whether or not the new shareholders are paying too much for their stock. Some states consider a price excessive if it is in excess of some predetermined multiple of the company's recent earnings.[60] Other states determine the excessiveness by the dilution suffered by the new shareholders at the time of their investment.[61]

Section 306(a)(2)(F) of the Uniform Securities Act authorizes the commissioner to deny registration if "the offering has been... made with unreasonable amounts or kinds of options".[62] To the extent that the promoters retain warrants or options to purchase equity of the company in the future, it will dilute the investment of the new shareholders. The premise here is that this dilution is unfair, because the new shareholders wind up with less of the company than is reasonable or, at least, less of the company than they anticipated. Although states have developed differing criteria for determining when warrants or options to the insiders[63] are excessive, typically states allow options and warrants for ten to twenty percent of the stock that will be outstanding at the completion of the offering.[64]

The substantive standards of merit regulations are also designed to protect public investors from exploitation at the hands of underwriters. The Uniform Securities Act, for example, permits the commissioner to deny registration if he or she finds that "the offering... has unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation."[65] As in the case of the merit standards aimed at promoters, these constraints on underwriters are designed to keep the underwriters from grabbing too much of the proceeds of the offering or too much of the company.[66]

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mitting the denial of applications to register securities of issuers with excessive cheap stock..." Goodkind, *supra* note 2, at 90.

Pursuant to a somewhat related concept, some states will deny registration of securities that are in the promotional or developmental stage unless the promoters have contributed a minimum percentage of the equity of the corporation. Arkansas is an example of this. ARK. SEC. COMM'R. R. 12.04, 1 BLUE SKY L. REP. (CCH) ¶ 10,484 (1984).

[57] *See, e.g.*, UNIF. SECURITIES ACT § 306(a)(2)(F), 7 U.L.A. 621 (1958).

[58] *See, e.g.*, KAN. ADMIN. REG. § 81-7-1(C). For an excellent survey of the way various states handle the problem of cheap stock, see Goodkind, *supra* note 2, at 90-93.

[59] One author, in a 1976 article, stated that "19 states have adopted some form of restriction on pricing." Goodkind, *supra* note 2, at 96.

[60] Iowa, for example, has a complicated formula that requires the issuer to file information "in justification" of any price that exceeds 25 times earnings. IOWA ADMIN. CODE, 510-50.35(502)(1983), IA BLUE SKY L. REP. (CCH) § 25,435 (1980); *See also, e.g.*, WIS. ADMIN. CODE § 3.02 (1983).

[61] *E.g.*, 808 KY. ADMIN. REGS. 10:080 (1983), IA BLUE SKY L. REP. (CCH) ¶ 27,498 (1980).

[62] UNIF. SECURITIES ACT § 306(a)(2)(F), 7 U.L.A. 621 (1958).

[63] In addition to promoters, underwriters are also often prohibited from taking excessive options. *See, e.g.*, UNIF. SECURITIES ACT § 306(a)(2)(F), 7 U.L.A. 621 (1958).

[64] *See, e.g., WIS. ADMIN. CODE* § 3.30(4) SEC (1984) (10% limit); WASH. ADMIN. CODE R. 460-16A-100 (1975), (20% limit).

There are two other types of merit regulation that deserve brief mention. First, some states will deny registration of non-voting equity securities unless those securities are preferred securities. *See, e.g.*, IND. ADMIN. CODE § 710:1-1-1, IA BLUE SKY L. REP. (CCH) ¶ 24,444 (1980). Second, some states will deny registration to senior securities unless the issuer can demonstrate the capability of servicing the interest or dividend requirements of the senior securities. *See, e.g.*, ARK. SEC. COMM'R. RUL. § 12.10, I BLUE SKY L. REP. (CCH) ¶ 10,490 (1980). This determination is made by the commissioner and his staff pursuant to various criteria developed by the states. *Id.*

[65] UNIF. SECURITIES ACT § 306(a)(2)(F), 7A U.L.A. 621 (1958).

[66] It has been pointed out, however, that underwriters' fees are a good barometer of risk, which should also be judged and controlled by the merit process. The idea here is that high underwriting fees mean that the issue will be a hard sell for the underwriter, which, in turn, means that the offering must be a high risk deal. As one author has stated, "excessive commissions... are a good indicator of the presence of the kind of investment risks that blue sky laws theoretically are designed to reduce." Goodkind, *supra* note 2, at 89.

States vary as to the percentage of the offering price that underwriters may take as commissions. Typically, however, states limit underwriters to commissions of ten to eighteen percent.[67] Also, states vary as to what items are included in the calculations of underwriters' commissions, although any cheap stock or warrants and options granted to underwriters are generally included.[68]

Proponents of merit regulation continue to argue its effectiveness, often bolstering their arguments with reports of their own experiences or actual statistical data. Writing in 1969, the Director of the Securities Bureau in Michigan reported that the "files in Michigan . . . are replete with cases where securities applications were withdrawn or never filed because of objections involving soundness or fairness and where the issuer subsequently met financial disaster."[69] Two other articles reported more systematic studies of the experience in particular states.[70] Those two studies reported that, based on certain criteria,[71] companies that were granted registration under the state's merit standards outperformed companies denied registration by the commissioner. One of those authors concluded that "the data . . . establishes a prima facie case for the utility of those registration standards in general."[72]

There seems to be no reason to doubt the conclusion that regulators can recognize deals that are risky and that, in such instances, investors will suffer no loss if the regulators deny permission to make the offering. This does not, however, resolve the more fundamental issue of whether society benefits from denying issuers access to public financing in such situations.It is not difficult to identify the pernicious impact of merit regulation. To the extent that merit regulation is used to deny issuers the right to register their securities, that pernicious impact can be significant. Simply stated, merit regulation unnecessarily constrains the freedom of people to do business as they see fit, discourages entrepreneurial initiative and impedes the flow of capital to its most efficient use.

By denying registration under existing merit standards, a state government is refusing promoters, underwriters and investors the right to do business and allocate risks and rewards of an enterprise in a way that each has determined to be in its own best interest. One should be denied the right to conduct his or her affairs as the person sees fit only if the benefits of such regulation outweigh the adverse consequences of the regulation, and that is not the case in the application of merit standards.

In addition, merit regulation is inconsistent with the very essence of a capitalistic system. If any capitalistic system is going to work, entrepreneurial initiative must be encouraged. Investors, promoters and underwriters must be encouraged to evaluate which enterprises society desires and allowed to divide the enterprises in a way that provides each with sufficient rewards to justify his participation.

Obviously one does not encourage a promoter to take the risk of forming and financing a new enterprise if regulators are permitted to limit the rewards a promoter can keep in the event the deal is successful. Just as obviously one does not encourage new enterprises by allowing regulators to limit the rewards underwriters can receive for their selling efforts. Capital formation and entrepreneurial initiative can be promoted only by allowing participants the possibility of rewards sufficient to justify their efforts.

Related to this is the question of who should control the flow and use of capital in this country. This author is convinced that the efficient use of capital requires that the market make this determination. When one decides to invest his capital, the investor has determined that the potential reward justifies the risk to his or her capital. This means, in an economic sense, that the investor believes (and is willing to risk his or her capital on the belief) that the invested capital will be used efficiently, since society, as a result of the utility derived from the enterprise, will reward the investor sufficiently to pay for the use of the capital. Without a clear and significant reason, regulators should not be permitted to interfere with this process.

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[67] *See, e.g.*, ARK. SEC. COMM R. RUL. § 12.02, 1 BLUE SKY L. REP. (CCH) ¶ 10,482 (1980)(10%); MASS. ADMIN. CODE tit. 950, § 13.05(2)(F) (1978) (18%).

[68] Some or all of the offering expenses are sometimes included in calculating the maximum amount allowed underwriters. See Goodkind, *supra* note 2, at 88-89.

[69] Hueni, *supra* note 15, at 1445.

[70] Walker & Hadaway, *supra* note 8; Goodkind, *supra* note 2, at 107 (describing a study of the experience in Wisconsin).

[71] The criteria used to measure performance in the Walker & Hadaway study included the following: dividends per share as a percentage of offering price; book value per share (annualized) as a percentage of offering price; and price per share (annualized) as a percentage of offering price. Walker & Hadaway, *supra* note 8, at 660.

[72] Goodkind, *supra* note 2, at 123. The other authors dodged this issue and merely "hypothesized that the efficacy depended on the relative performance of the approved and withdrawn groups." Walker & Hadaway, *supra* note 8, at 679.

Capital should be permitted to flow into those enterprises and uses that the market demands.

In discussing the possible benefits to society of merit regulation, it is essential that one avoid an overly emotional, knee-jerk analysis. One should be suspicious of attempts to justify merit regulation on the basis that it saves the unprotected and unsophisticated investor from squandering a life's savings on some dishonest promoter's fraudulent scheme. Professor Bloomenthal has convincingly argued that merit regulation is no serious impediment to the perpetration of fraud.[73] Promoters with fraud on their minds can either omit to comply with state securities laws or, alternatively, comply with those laws and then waste, mismanage or steal the proceeds of the offering.[74] Obviously merit regulation cannot, and one would assume is not intended to, prevent such abuses. Rather, remedies in those situations must come from the disclosure and antifraud provisions of the applicable laws[75] and from state fiduciary laws.

More to the point, however, it simply is not true that investors, without the benefit of merit regulations, are unprotected. Most obviously, these investors are protected by the disclosure and antifraud provisions of securities legislation. This should not be overlooked. An issuer must either register each offering with the SEC or find an exemption from the registration requirements. In addition, any material omission or misstatement made in connection with a sale of securities is actionable under applicable antifraud standards. As has been discussed earlier, these provisions offer substantial protection to investors.

Finally, one must not overlook the protection afforded by market forces and the availability of alternative investments. Especially as the deregulation of the banking industry has continued, the competition for money among institutions has increased dramatically. Banks now have various types of accounts that pay a fair market rate for depositors' money. Also, each major brokerage firm has various investments that pay fair rates of return. Certainly, one would concede that the availability of these investments is well known, as, for example, newspapers regularly run advertisements of banks and other institutions soliciting for these investments.

The point of all this is to dispel the notion that merit regulation protects helpless and hapless investors who, with purity and naivete, invest in fraudulent schemes. People who invest in schemes that would not pass muster under merit regulations are people who are otherwise unhappy with the rates of return that are being paid by banks and similar institutions on more conservative investments. Indeed, one could argue in these circumstances that the only effect of merit regulation is to protect investors from their own stupidity and greed. Society should not be asked to pay much for this.

CONCLUSION

The costs of blue sky regulation, while sometimes difficult to identify and usually impossible to quantify, are not, by all evidence, insubstantial.[76] States, for example, annually spend millions of dollars promulgating, administering and enforcing blue sky laws. Each year, the North American Securities Administrators Association (NASAA) solicits information concerning the funding, expenditures and revenues of the states' blue sky divisions. For the year 1983, this author received the NASAA information on thirty states, which reflected total expenditures of approximately

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[73] Bloomenthal, *Blue Sky Regulation and the Theory of Overkill,* 15 WAYNE L. REV. 1447, 1481 -84 (1969).

[74] *Id.*

[75] This author would argue that federal securities laws are the appropriate source of protection in this area.

[76] In his book, CORPORATE FINANCIAL DISCLOSURE IN THE UK AND USA, Benston categorizes the costs that may be generated by the disclosure requirements of federal law as direct costs, indirect costs and opportunity costs. G. BENSTON, CORPORATE FINANCIAL DISCLOSURE IN THE UK AND THE USA (1976). Direct costs include, for example, the costs paid by an issuer to register with the SEC or to qualify for an exemption from such registration. Direct costs to the government include the costs associated with reviewing registration statements and otherwise enforcing securities laws. *Id.* at 154. Benston cites the reported difficulty of corporations in finding competent outside directors, due to the added risk and pressure that compliance with securities laws places on such directors, as an example of indirect expenses of securities regulation. *Id.* at 155. Finally, Benston points out that the added burden caused by regulation of securities at the federal level can result in delays in offerings and even in the failure to undertake or complete securities offerings. Benston labels the costs associated with such delays and incompletions as opportunity costs. *Id.*

$25.6 million for all thirty divisions.[77] The average expenditure of each reporting state, therefore, was approximately $853,124, which leads one to infer that total expenditures for all states may be as much as $40 million.[78]

Blue sky laws also involve significant direct costs to the issuers of securities. For example, an issuer involved in a registered offering is required to "blue sky" the offering in each state in which selling activity is to occur. In 1983, approximately 5,000 registration statements became effective with the SEC.[79] If one were to assume that each of these registration statements involved $10,000 in legal expenses for the blue sky work,[80] total legal fees for all these offerings would be approximately $50,000,000.

Additionally, there are thousands of unregistered offerings each year, which may involve substantial legal expenditures in order to insure compliance with applicable blue sky laws. Regarding the number of such unregistered offerings, the SEC received filings[81] indicating that there were approximately 11,000 Regulation D offerings during 1983.[82] Since no such filings are required for intrastate offerings or offerings under Section 4(2), no valid indication is available for the number of such offerings. Regarding the costs of "blue skying" these unregistered offerings, one should not assume that the costs are necessarily insubstantial.[83] Although most unregistered offerings involve offers to a limited number of persons, which will tend to reduce the number of states involved in the unregistered offering, the problems, to some extent, are sometimes more complicated than those encountered in a registered offering.[84]

This description of costs is not intended to be precise or to be exhaustive of the costs to society of blue sky regulation. It is, however, intended to suggest that millions of dollars are spent each year on a system of regulation that provides no significant protection to investors and retards capital formation. Only legislative inertia and bureaucratic entrenchment can explain this present state of affairs.

The Legislation provides a sensible, if somewhat incomplete, remedy for the problems discussed above. Wisely, the Legislation does not limit the state role in the enforcement of state antifraud laws and regulations. States are left free, therefore, to invest resources to enforce these antifraud laws to the extent they see fit.

Mr. OXLEY. Thank you, Professor.

Mr. McDaniel.

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[77] NASAA refused to supply complete information to this author. At first the officials of NASAA agreed to supply the information, but, after further reflection, they concluded that the information was "proprietary" and, therefore, that they could not release the information.

[78] This inference is based on the assumption of approximating 50 divisions that enforce blue sky laws . The information that this writer obtained for 1982 indicates smaller expenditures than the 1983 results reported in the text. For 1982, this writer obtained information on 25 states, which spent a total of approximately $14.8 million to support their blue sky divisions. This was an average of approximately $572,000 per state, which would indicate total expenditures (based on 50 divisions) of approximately $28 million.

The difference between the 1983 and 1982 numbers appears principally to be caused by the particular states included in the available information. For example, this writer did not have information on California for 1982. In 1983, California reported a budget of $7,264,000. Other large budgets for 1983 included Ohio, approximately $2.5 million, and Texas, approximately $1.9 million.

[79] Telephone conversation with an employee of the Securities and Exchange Commission on March 22, 1984.

[80] This writer's experience and conversations with other attorneys indicate that the legal expenses associated with a broadly distributed, registered offering may reach $25,000. Legal expenses can, of course, be significantly less, depending upon the breadth of the distribution, the skills of the law firm, the firm's hourly rate and other factors.

[81] Form D must be filed with the Commission for each offering made under Regulation D. 17 C.F.R. § 230.503 (1984).

[82] Telephone conversation with an employee of the Securities and Exchange Commission on June 21, 1984.

[83] While in practice in 1980, this author was involved in an offering under old Rule 146. He cleared that exempt offering in approximately 30 states. The legal fees for that blue sky work were approximately $8,000. This author is aware of a later deal under Regulation D that was cleared in nearly 50 states, where the legal expenses probably approached $20,000.

At the other end of the spectrum, deals completed under an intrastate exemption may not involve any significant legal expenses for blue sky work, because only one state is involved.

[84] For example, in registered offerings an issuer may not be faced with any significant broker-dealer questions, since the deals are often sold by registered, professional brokers. Unregistered offerings, on the other hand, are usually sold without the aid of professional underwriters and thus raise questions of whether the persons involved in the sale campaign may fall within the definitions of "broker-dealer" or "agent." See *supra* text accompanying notes 124-32.

STATEMENT OF MOREY W. McDANIEL

Mr. McDANIEL. Mr. Chairman, members of the subcommittee, I want to thank the subcommittee for this opportunity to support the repeal of the Trust Indenture Act of 1939, which is without a doubt the most obscure and outdated of the Federal securities laws.

A few words about my background. For 8 years I was an attorney with the Wall Street Law Firm of Cravath, Swaine & Moore. During that time, I represented underwriters in public bond offerings. For 20 years after that, I was Chief Finance Counsel at Union Carbide where I represented the company in numerous offerings of corporate bonds.

In 1980, I developed a simplified bond contract which today is widely used by corporate borrowers throughout the United States. Also, I am the author of six law journal articles on bondholder rights.

Now, the Trust Indenture Act does two things: First, it requires every company selling bonds that are registered with the SEC to go out and hire a trustee. The second thing the act requires is the unanimous consent by bondholders to any change in principal or interest payments, and those two things are what's wrong with the act.

The bond market is dominated by large institutions. When those institutions want certain covenants for protection, they demand them. Likewise, if institutions want a trustee, they can demand one. If they don't care about a trustee, the law should not compel a company to go out and pay for a trustee nobody wants.

Now, what does a trustee actually do? As it turns out, not much. Prior to a default, a trustee has no fiduciary duties and does nothing. Since most companies never default on their bonds, most trustees never do anything.

If a default should occur, the first thing most trustees do is resign. Just when you need them, they quit.

Trustees are redundant. If a company defaults and goes into bankruptcy, the company's directors at that point owe fiduciary duties to their creditors. In addition, the creditors committee that the bankruptcy court appoints also owes fiduciary duties to the creditors. So trustees are just another layer in the fiduciary cake.

In Europe, bond issuers are not required to hire trustees and when foreign issuers sell bonds in the U.S. and exempt transactions, many times there is no trustee.

Now, some bond buyers may think a trustee adds value. That is fine. They can ask for a trustee. If trustees are worthwhile, they will survive. But let the market decide that, not the Congress or the SEC.

The second thing wrong with the Trust Indenture Act, as I mentioned, is this: It requires unanimous consent by bondholders to any change in principal or interest payments. In bankruptcy, a two-thirds majority can buy—bind creditors. Since holdouts can block any voluntary arrangement with creditors outside of bankruptcy, a company is forced to go into bankruptcy and suffer the additional costs, uncertainty, delay and stigma of a bankruptcy proceeding. This is truly perverse public policy.

The Trust Indenture Act is a misfit among the Federal securities laws. While other securities laws promote full disclosure, the Trust

Indenture Act does something else. It dictates substantive terms: You shall hire a trustee. A trustee shall have these qualifications. The trustee shall do such and such. You shall get 100 percent of the votes to change principal or interest, et cetera.

Enough of these shalls and shall-nots. Bond issuers and bond buyers do not need any help in writing their bond contract. Mandatory contract terms are out of place in an institutional market and they are out of place in a disclosure-based regulatory system.

The Trust Indenture Act was enacted over 50 years ago when the bond market was far different. Federal statutes are not like Federal furniture. They don't get better with age. They get worse. The Trust Indenture Act belongs to the past. It should be repealed.

Thank you.

[The prepared statement of Morey W. McDaniel follows:]

PREPARED STATEMENT OF MOREY W. MCDANIEL

Mr. Chairman, Members of the Subcommittee: I thank the Subcommittee for this opportunity to support the repeal of the Trust Indenture Act of 1939 (TIA), which is without doubt the most obscure and outdated of the federal securities laws.

A few words about my background. For eight years I was an attorney with the Wall Street law firm of Cravath, Swaine & Moore. During that time, I represented underwriters in public bond offerings. For 20 years thereafter, I was chief finance counsel at Union Carbide, where I represented the company in numerous offerings of corporate bonds. In 1980, I developed a simplified bond contract (i.e., an indenture), which today is widely used by corporate borrowers throughout the U.S. Also, I am the author of six law journal articles on bondholder rights.

The TIA does two things: First, it requires every company selling bonds registered with the SEC to hire a trustee. Second, it requires unanimous consent by bondholders to any change in principal or interest payments. And those two things are what's wrong with the Act.

The bond market is dominated by large institutions. When institutions want certain covenants for protection, they demand them. Likewise, if institutions want a trustee, they can demand one. If they don't care about a trustee, the law should not compel a company to pay for a trustee no one wants.

Now, what does a trustee actually do? As it turns out, not much. Prior to a default, a trustee has no fiduciary duties and does nothing. Since most companies never default on their bonds, most trustees never do anything. If a default should occur, the first thing most trustees do is resign. Just when you need them, they quit. So you have to go out and find a replacement trustee.

Trustees are redundant. If a company defaults and goes into bankruptcy, the directors owe fiduciary duties to the creditors. Further, the creditors' committee that the bankruptcy court appoints also owes fiduciary duties to the creditors. So trustees are just another layer in the fiduciary cake.

Not only are trustees redundant, too often they are little more than functionaries, noted mainly for their passivity, inertia and indecision.

In Europe, bond issuers are not required to hire trustees. And when foreign issuers sell bonds in the U.S. in exempt Rule 144A transactions, many times there is no trustee.

Now, some bond buyers may disagree. They may think a trustee adds value. Fine. They can ask for a trustee. If trustees are worthwhile, they will survive. But let the market decide, not the Congress or the SEC.

The second thing wrong with the TIA, as I mentioned, is this: It requires unanimous consent by bondholders to any change in principal or interest payments. The unanimity requirement has a pernicious effect. Since holdouts can block an arrangement with creditors, voluntary workouts are impossible.

In bankruptcy, a two-thirds majority can bind a class of creditors. This has led to the "prepackaged bankruptcy" where a company negotiates an arrangement with major creditors then files for bankruptcy in order to bind holdouts. So even if a troubled company can negotiate a voluntary workout, the company is forced by the TIA to file for bankruptcy and suffer the additional costs, uncertainty, delay and stigma of a bankruptcy proceeding. This is perverse public policy.

The TIA also requires a company to file an annual compliance certificate with the trustee. Again, bond buyers, as with other covenants, can demand whatever compli-

ance certificates, notices, or financial information they want. Let the marketplace decide these details.

Furthermore, it is not the trustee but a company's public accountants that monitor covenant compliance. If a company is in default and its debt can be accelerated, the accountants will reclassify the debt from long-term to short-term. If the default and debt reclassification are serious enough, the company will have to make a public announcement of its predicament. The trustee plays no part in this process.

The TIA is a misfit among the federal securities laws. While other securities laws promote full disclosure, the TIA does something else—it dictates substantive terms: You shall hire a trustee, the trustee shall have these qualifications, the trustee shall do such and such, you shall get 100% of the votes to change principal or interest, etc. Enough of these shalls and shall nots. Bond issuers and bond buyers don't need any help in writing their bond contract. Mandatory contract terms are out-of-place in an institutional market, and out-of-place in a disclosure-based regulatory system.

The TIA was enacted over 50 years ago when the bond market was far different. For example, in those days, mortgage bonds and bearer bonds were common. Today, public utilities are about the only companies still issuing mortgage bonds. As for bearer bonds, the IRS abolished them some years ago.

Federal statutes are not like Federal furniture; they don't get better with age, they get worse. The TIA belongs to the past. It should be repealed.

Thank you.

Mr. OXLEY. Thank you, Mr. McDaniel.

Mr. Belt.

STATEMENT OF BRADLEY D. BELT

Mr. BELT. Thank you, Mr. Chairman.

I am delighted to have this opportunity to appear before the committee to discuss H.R. 2131 and express my strong support for your efforts.

As you noted, my name is Brad Belt, and I am the Director of the Capital Markets Project at the Center for Strategic and International Studies. This project was initiated with the express purpose of bringing together policymakers, the academic community and industry leaders to examine the kinds of issues that you have raised in your legislation, Mr. Chairman.

Let me note at the outset, that while I believe a top-to-bottom review of the Federal securities laws is timely and appropriate as a result of marketplace developments, this review does not mean, of course, that the current system, regulatory system, is broken. It is a point raised by Mr. Markey earlier this morning.

Indeed, we have a high quality regulatory system that has fostered securities markets that are the envy of the world. This is not an accident of history. It is the direct result of a statutory and regulatory system grounded in the concept of full disclosure, a system that has been thoughtfully and responsibly administered by the SEC for over 60 years.

Concurring with Professor Campbell, my view is that responsible regulation actually facilitates the capital formation process and is a competitive advantage. Therefore, it is not necessary and would not be wise to make wholesale changes to the current legal and statutory framework simply for the sake of change.

However, it would be just as unwise to rest on our laurels and not make changes that enable our markets and our market participants to function more effectively while maintaining our high standards of investor protection. Just as this committee has acted to modernize our Nation's telecommunications laws, which are just as old as our securities laws, in response to changes in technology and market structure, it should also act to modernize our Nation's

securities laws to ensure that our markets and market participants can compete effectively in an intensely competitive and dynamic global marketplace. The fact is that the world has changed considerably since the Federal securities laws were enacted in 1930.

Cross-border trading and market linkages, the growing importance of institutional investors and increasing sophistication of financial consumers and advances in computer and telecommunications technology have revolutionized the world's financial markets. And the blurring of lines between financial service providers and the development of new financial products and trading strategies has resulted in instances of regulatory overlap, imposing duplicative and unnecessary costs on market participants, as well as instances of regulatory gaps that raise investor protection and systematic risk concerns. These developments present new opportunities for market participants and pose new challenges for financial regulators.

Most of the changes needed to accommodate marketplace developments can and should be addressed administratively through agency rulemaking. This approach provides the greatest flexibility and the SEC is best positioned to respond to new developments. The Commission, the SEC, deserves credit for launching a number of important regulatory initiatives designed to modernize and streamline the existing regulatory scheme.

By the same token, it is the responsibility of Congress to establish the framework of regulation. In addition, some in some areas, regulators lack the statutory authority to respond appropriately to marketplace developments and thus legislation is necessary to ensure the continued protection of investors, to enhance the efficiency of the capital-raising process and to position U.S. markets to be competitive in the 21st Century.

Mr. Chairman, while I do not subscribe to every provision in H.R. 2131 as drafted, I strongly support the concepts embodied in the legislation and believe that the introduction of the bill has already had a salutary effect. You and the committee are to be commended for stimulating a constructive debate of issues of critical importance.

Before discussing the specific provisions of H.R. 2131, I would like to simply mention the regulatory principles that we believe should guide an assessment of appropriate public policy in the financial arena. These principles, which are discussed more fully in my prepared statement, include, first, that regulations should facilitate the process of capital formation; second, that regulation should strike a balance among often competing goals and objectives; third, that regulation should be integrated and integrative; fourth, that regulation should provide clarity and certainty to market participants; finally, that regulation should be based on performance standards, not command and control edicts.

Mr. Chairman, with respect to H.R. 2131, I support your efforts to clarify the application of suitability rules to institutional investors, to establish a more rational, workable allocation of responsibilities between State and Federal securities regulators; to broaden the SEC's statutory mission to include efficiency competition and capital formation concerns; to modernize the prospectus delivery requirements and to broaden the SEC's exemptive authority.

I have concerns, however, about the outright repeal of several of the provisions of the Williams Act, and I believe there is enough work at the SEC for five commissioners. I discuss each of these issues in greater detail in my prepared testimony.

I would like to mention that there are several additional securities law reforms that also should be considered in the context of the broader review of the current statutory and regulatory framework. In particular, I support the bill that you and Representative Markey have introduced to revise the Investment Company Act.

It would also be appropriate to examine the issue of listing standards for foreign issuers and the development of internationally acceptable accounting standards.

Mr. Chairman, prudent reforms will benefit investors in the markets as a whole.

I thank you for allowing me to opportunity to appear before you and I would be pleased to answer any questions.

[The prepared statement of Bradley D. Belt follows:]

PREPARED STATEMENT OF BRADLEY D. BELT, DIRECTOR OF CAPITAL MARKETS AND DOMESTIC POLICY ISSUES, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

Mr. Chairman, Representative Markey, Members of the Committee. I am delighted to have this opportunity to appear before this Committee to discuss H.R. 2131, the "Capital Markets Deregulation and Liberalization Act of 1995" and to express my support for your efforts. This is my first opportunity to testify before this Committee as the executive director of the Capital Markets Regulatory Reform Project sponsored by the Center for Strategic and International Studies.[1] This project was initiated with the express purpose of bringing together policy-makers, the academic community, and industry leaders to examine the kinds of issues that you have raised in your legislation Mr. Chairman, and to provide policy input on issues related to the continued health and vitality of our nation's capital markets.

Let me emphasize at the outset, Mr. Chairman, that while I believe that a top to bottom review of the federal securities laws is necessary and appropriate as a result of marketplace developments, I do not mean to suggest that the current regulatory system is "broken." Indeed, we have a high quality regulatory system that has fostered securities markets that are the envy of the world and justly renowned for their depth, liquidity and integrity. This is not an accident of history. It is the direct result of a statutory and regulatory system grounded in the concept of full disclosure—a system that has been thoughtfully and responsibly administered by the Securities and Exchange Commission for over 60 years.

It is not necessary, and would not be wise, to make wholesale changes to the current legal and regulatory framework simply for the sake of change. It would be just as unwise to rest on our laurels and not make changes to the existing legal and regulatory framework that will enable our markets and market participants to function more effectively, while maintaining our high standards of investor protection. Just as American companies have undergone a reengineering process to make themselves more competitive, and just as this Committee has sought to modernize our nation's telecommunications laws in response to changes in technology and market structure, so to must we act to thoughtfully and responsibly review the regulation of U.S. securities markets to ensure that our markets and market participants can compete effectively in an intensely competitive and dynamic global marketplace.

The fact is that the world has changed considerably since the federal securities laws were enacted in the 1930s, since the last comprehensive review of securities markets was conducted in the early 1960s,[2] and since the national market system amendments were adopted in 1975.[3]

Cross-border trading and market linkages, the growing importance of institutional investors and increasing sophistication of financial consumers, advances in com-

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[1] CSIS is a non-profit public policy research institute based in Washington, DC that provides policymakers with a strategic perspective on issues relating to international finance, economics, and global security matters. The views expressed herein are my own and do not necessarily represent the views of CSIS or any persons affiliated with it.

[2] *Report of Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st. Sess. (1963).

[3] The Securities Acts Amendments of 1975, 89 Stat. 97, P.L. 94-29 (June 4, 1975).

puter and telecommunications technology have revolutionized the world's financial markets. And the blurring of lines between financial service providers and the development of new financial products and trading strategies has resulted in instances of regulatory overlap, imposing duplicative and unnecessary costs on market participants, as well as instances of regulatory gaps that raise investor protection and systemic risk concerns.

These developments present new opportunities for market participants and pose new challenges for financial regulators. As Securities and Exchange Commission Chairman Arthur Levitt noted last week in his testimony before this Committee, "we need to determine how to keep the securities regulatory framework up to date; how to promote rather than impede, market growth and development, while at the same time providing effective investor protection and supporting... investor confidence."[4]

Most of the changes needed to accommodate marketplace developments can, and should, be addressed administratively through agency rulemaking. This approach provides the greatest flexibility and the SEC is best positioned to respond to new developments. Chairman Levitt, Commissioner Wallman and the staff of the Commission deserve credit for launching a number of important regulatory initiatives designed to modernize and streamline the existing regulatory scheme.

By the same token, it is the responsibility of Congress to establish the framework for regulation. In addition, in many areas, regulatory authorities have, as Chairman Levitt has noted, "hit a statutory wall"—the regulators lack the statutory authority to respond appropriately to marketplace developments.[5] Therefore, legislation is necessary to ensure the continued protection of investors, to enhance the efficiency of the capital raising process, and to position U.S. markets to be competitive in the 21st century.

Mr. Chairman, while I do not personally agree with each and every provision in H.R. 2131 as drafted, I strongly support the concepts embodied in the legislation and believe that the introduction of the bill already has had a salutary effect. You and the Committee are to be commended for stimulating a constructive debate on issues of critical importance.

You requested that I discuss the specific provisions of H.R. 2131. Before doing so, however, I would like to briefly review the dramatic ways in which markets have changed in recent years and outline some of the principles that are informing our review of appropriate public policy in the financial arena.

THE EVOLUTION OF CAPITAL MARKETS

The legal and regulatory framework for financial services in this country was erected in the shadow of the Great Depression some 60 years ago and was designed to address the abuses of the industrial age, not to meet the challenges of the information age. The federal securities laws were a response to the perceived abuses practiced upon unsuspecting investors by the corporate titans of the day, who wielded immense power.[6]

Moreover, our securities laws and regulations have evolved in a haphazard and episodic fashion, as a response to the crisis of the day rather than part of a deliberate and broadly conceived approach to capital markets regulation. In many cases, the statutes provide no more than a skeletal framework for a comprehensive and elaborate series of rules and regulations adopted pursuant to broad grants of statutory authority. The formal rules and regulations promulgated by the financial regulators have the force of law and currently comprise several volumes in the Code of Federal Regulations.

The formal regulations are, in turn, dwarfed by the extraordinary volume of interpretative releases, no-action letters, and other formal and informal pronouncements of policy. In the words of the dean of securities law scholars, Professor Louis Loss, the "inevitable result of this episodic kind of legislation... is a great many inconsistencies, a considerable number of gaps and overlaps, and in general needless complexity in a field of law that would not make light bedtime reading at its best."[7]

It would be a worthy exercise in and of itself to streamline and rationalize this rather convoluted statutory and regulatory scheme. In fact, this was a project that

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[4] Testimony of Arthur Levitt before the Subcommittee on Telecommunications and Finance, U.S. House of Representatives, November 30, 1995.

[5] Remarks of Arthur Levitt to the American Bar Association Capital Markets Symposium, September 16, 1994.

[6] See generally, J. Seligman, *The Transformation of Wall Street* (Houghton Mifflin Company Boston 1992).

[7] See Louis Loss, *Fundamentals of Securities Regulation* 2d. ed. (New York, Little, Brown & Company, 1988), p. 38-39.

was undertaken by the American Law Institute in the late 1960s that culminated in the development of a proposed Federal Securities Code. While the proposed Code was printed in bill form by this Committee, it was never acted on. More importantly, however, fundamental forces have shaped the capital markets in ways that simply could not have been envisioned by the drafters of the original securities acts. These developments, discussed below, provide a compelling argument for a thorough review of the existing statutory and regulatory framework for securities markets.

Internationalization

Capital flows ever more freely across national borders in search of the highest return relative to a given level of risk. Companies and governments can now routinely tap virtually any of the world's securities markets to raise necessary investment capital, and investors have demonstrated a willingness to purchase securities of issuers outside their "home" markets.[8] There also has been a substantial increase in cross-border secondary market trading activity. Both formal and informal trading markets operate on a 24-hour basis. The volume of U.S. securities traded by foreign investors grew sixfold over the last decade, from $125 billion in 1984 to more than $700 billion in 1994.[9] The growth in trading of foreign securities by U.S. investors during this period is even more impressive—from $30 billion to $815 billion, an average increase of nearly 40 percent per year.[10] Securities trading in turn is dwarfed by the volume of non-securities financial transactions. For example, daily foreign exchange trading exceeds *$1 trillion.*

By choosing among different markets, borrowers access new sources of capital and do so at lower costs. They also use these markets to hedge currency and interest rate risks. Investors, large and small, look to foreign markets for new profit opportunities and to diversify their portfolios. New opportunities can also bring new risks, however, and as Federal Reserve Chairman Alan Greenspan has noted, present new challenges to regulators.[11] Moreover, while U.S. regulators have made a number of accommodations to issuers and investors seeking to take advantage of marketplace developments, there is a very real concern as to whether our legal structure, which was designed in contemplation of self-contained national markets,[12] is sufficiently flexible to be able to maximize the benefits and minimize the risks posed by the increased internationalization of markets.

Institutionalization

Capital markets are now dominated by institutional participants (e.g., mutual funds, public and private pension funds, insurance companies, and bank trust departments). This is in stark contrast to earlier decades, when retail investors accounted for nearly 90 percent of U.S. equity holdings.[13] Today, institutions hold nearly half of all U.S. equities[14] and account for three-quarters of the trading volume on listed exchanges. In fact, block trading, usually trades of 10,000 or more shares, accounted for over half of reported volume in 1993.[15] Institutions are even more dominant in over-the-counter and overseas markets. In certain market segments, and with regard to the trading of certain kinds of investment products, market activity is wholly institutional.

The increasingly dominant presence of institutional investors has had a profound impact on U.S. capital markets, affecting volatility, liquidity, allocation of resources, and corporate governance. The question arises, however, whether laws and regulations that are principally intended to benefit retail investors are unnecessary for institutional investors, and, more importantly, whether they result in more costly and inefficient markets. Nobel-laureate economist Merton Miller has argued that there is no justification for regulating wholesale markets.[16] Other commentators would not go as far, but have nonetheless suggested a tiered regulatory structure, with much greater regulatory scrutiny given to retail than to wholesale markets. To some extent, the SEC has fostered the development of a limited two-tier market through Rule 144A by encouraging foreign issuers to sell to qualified institutional buyers

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[8] Greene, Braverman and Sperber, "Internationalization of the World's Capital Markets: U.S. Regulatory Alternatives," paper presented to the American Bar Association Capital Markets Symposium, Sept. 16, 1994.

[9] *1995 Securities Industry Fact Book,* Securities Industry Association, (citing U.S. Treasury Department data), p. 82.

[10] Ibid.

[11] Remarks of Alan Greenspan to the Financial Markets Conference of the Federal Reserve Bank of Atlanta, March 3, 1995.

[12] P. Mahoney, "Regulation of International Securities Issues," *Regulation* (Spring 1991), p. 63.

[13] 1994 New York Stock Exchange Fact Book at p. 83.

[14] Ibid.

[15] Ibid p. 100.

[16] *Economist,* July 22, 1995, p. 65.

(specifically excluding retail investors) without registration under the Securities Act of 1933.

Product Innovation

The past two and a half decades have seen the introduction of a dizzying array of new financial products and trading techniques. In 1993, the Comptroller of the Currency identified nearly 900 types of derivatives.[17] Growth in volume of derivative financial products transactions is staggering. According to the International Swaps and Derivatives Association, derivatives transactions increased 47.4 percent in 1994 to over *$8.1 trillion* in notional value from just over $5.5 trillion in 1993.[18] Derivatives, and the trading strategies employing them, have become an important risk-management tool enabling money managers to hedge currency and interest-rate risks, tactically allocate assets, and increase or decrease their underlying equity exposure more rapidly and at much lower cost than affecting these strategies in the cash market.

However, the increased use of derivatives has raised a number of issues concerning appropriate regulatory policy. Many derivative financial products are complex and extremely sensitive to changes in the prices of the underlying asset. Failure to understand the dynamic nature of these products and employ appropriate risk-management systems can lead to extraordinarily large losses in a short period of time, especially with leveraged positions. Losses of larger magnitude threaten the viability of not only individual institutions, but raise systemic concerns, as well.

Moreover, as financial engineers continue to slice, dice and reconfigure financial instruments to create derivative products tailored to meet the risk-reward demands of investors and issuers, it increasingly is apparent that these instruments do not fit easily within traditional product classifications, i.e., within the definition of a security, no matter how expansively read, and regardless of traditional notions of what constitutes debt and equity instruments, banking products, or futures contracts. Product innovation already has engineered a series of regulatory crises, the most notable of which gave rise to the Shad-Johnson accord in 1982, a jurisdictional battle between the Commodity Futures Trading Commission (CFTC) and SEC over index participations, and continued squabbling among regulatory agencies over variations in bank investment products and annuities, as well as a substantial amount of litigation. Continuing uncertainty over the legal status of many hybrid financial products raises costs and chills innovation.

Technological Advances

Advances in computer and telecommunications technology have combined to make possible the developments noted above. In the 1930s, customer orders were carried by runners across the street or sent by pneumatic tube to a floor broker. Today, technology permits financial transactions—tens of thousands of transactions, with values of more than a trillion dollars—to occur electronically, instantaneously, at all hours of the day. Private sector firms are investing hundreds of millions of dollars in cutting-edge technologies in order to stay competitive. Information is disseminated on a real-time basis and markets can react in a matter of minutes or seconds. Without these advances in communications and information technology, derivative financial products and computer-based trading strategies could not have been developed.

Given the increasing importance of technology, it is questionable whether regulators have the means to be "competitive" and match the technological capabilities of the private sector. In some cases, when presented with a technological "threat" to their authority, such as program trading, the reaction of regulators sometimes has been to throw sand in the gears in a futile attempt to maintain the relevance of existing regulatory structures and policies. As to means, CS First Boston has spent an estimated $800 million on technology during the past three years[19] and the New York Stock Exchange has installed over $1 billion in new technology since 1985.[20] In contrast, the entire budget of the SEC is just $300 million, which in turns dwarfs the CFTC's budget of just $50 million.

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[17] "OCC Eyes Lid on Use of Swaps by Banks," *American Banker* (April 21, 1994), p. 1.

[18] International Swaps and Derivatives Association, Inc.

[19] Allen Wheat, "Glass-Steagall versus the Market: The Market Wins," *Investment Dealer's Digest* 61 (May 22, 1995), p. 21.

[20] Philip Maher, "The New Wall Street: On to the Millenium," *Investment Dealers Digest* 61 (May 22, 1995), p. 10.

THE COMING REVOLUTION IN CAPITAL MARKETS

As significant as these changes have been, however, there are more profound, revolutionary changes on the horizon that will fundamentally alter the way in which capital markets operate in the next century. We are on the precipice of a brave new world of "e-money," "cybercash," and "nuclear" finance that promise both extraordinary opportunities for market participants and extraordinary challenges for regulators.

Electronic Commerce

We are rapidly entering an era of electronic commerce. Leading financial services firms have been acquiring, merging, or entering into joint ventures, with telecommunications firms and computer software companies to best position themselves to take advantage of the information superhighway. Soon, consumers will be able to conduct virtually all of their personal finance and investment transactions through their own computer terminal. Brick and mortar edifices will give way to virtual banks and brokerage firms.

Last month, Security First Network Bank became the first financial institution to offer full-service banking on the Internet.[21] Smith Barney recently announced that it plans to allow its clients to execute stock trades over the Internet.[22] A company called First Virtual allows consumers to use credit cards for purchases on the Internet.[23] Intuit Corp. recently announced that 20 of the largest financial firms in the U.S. will be using the company's personal finance software package, Quicken, to enable their customers to conduct banking transactions on-line.[24] Consumers will have a single point of access to banking, credit and debit card services, brokerage, and financial planning. Nor will market definition issues be limited to our own border; *Business Week* recently ran a story entitled "On-line Investing" in which the reporter noted that he began every day by logging onto the Zagreb Stock Exchange to peruse "prospectuses" of local issuers.[25] A British company plans to establish the first organized stock exchange on the Internet.[26]

While virtual markets hold great promise for consumers, they also pose a number of risks, especially with regard to privacy and fraud issues. They also create enormous problems for regulators. Who sets the standards for cyberspace? What is the situs of a transaction that occurs on the Internet? If it is cross-border, who will regulate the transaction? If an electronic money flow and payments system develops outside the traditional banking system, what are the implications for effecting monetary policy?

"Hot" Money Flows

The Mexican peso crisis late last year, as well as the 1987 market crash and 1992 assault on the pound sterling, provide dramatic evidence of the volatile character of private capital flows. Billions of dollars of capital can move in or out of markets within a matter of minutes, and the risk that disturbances in one market will be transferred to other markets has heightened.

Global money managers have the capacity to undermine national economies and severely punish those countries that pursue unsound fiscal policies. This extraordinary power calls into question the continued ability of national regulators to exercise authority over global markets and market participants, of national policymakers to manage macroeconomic policy, and of national and international regulators to cushion liquidity crises and prevent the spread of contagion to multiple markets.[27] This will require a careful balancing act on the part of regulators and policymakers; just as ill-considered economic policies are severely punished, ill-considered regulations will drive capital to less costly regulatory regimes.

Nuclear Finance

For the past decade or more, financial engineers have been reconfiguring traditional financial instruments into new products that are tailored to meet the risk-

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[21] Vic Sussman, "Gold Rush in Cyberspace," *Business Week* (November 13, 1995), p. 74.

[22] Jayne Levin, "Smith Barney to Launch On-Line Trading," *Wall Street Letter* (November 13, 1995), p. 1.

[23] Kelley Holland and Amy Cortese, "The Future of Money," *Business Week* (June 12, 1991), p. 68-69.

[24] Timothy O'Brien, "Intuit to Unveil On-Line Pact with 20 Firms, *Wall Street Journal* (July 14, 1995), p. A3.

[25] "On-line Investing," *BusinessWeek* (June 5, 1995), p. 64.

[26] Harvey Shapiro, "Trading Places," *Hemispheres* (August 1995), p. 79.

[27] A colleague at CSIS recently published a thoughtful article on this subject, arguing that financial markets are the new "global hegemon." Erik Peterson, "Surrendering to Markets," *The Washington Quarterly* (Autumn 1995), p. 103.

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reward demands of market participants. Now, new advances in financial theory, including portfolio, asset pricing, option pricing, volatility, and market efficiency theories, are leading a more rigorous study of the nature, measurement, and management of risk.[28] This, in turn, is pushing the envelope of current accounting and financial reporting constructs.

Issuer risks bundled in traditional equity and debt instruments are being disaggregated into more discrete units. The ability to disaggregate, describe, and package issuer risks potentially offers investors more precisely price issuer risks—not only credit, interest rate, and currency risks, but operational, management, economic, market, country, and legal risks, as well as more esoteric "alpha" risks. This "atomization" of risk raises issues not only with regard to accounting and disclosure policies, but also with respect to the current system of corporate governance—if equities are unbundled, who then "owns" the company?

POLICY IMPLICATIONS

These developments present extraordinary opportunities for market participants and pose extraordinary challenges for regulators. Generally, market participants have been quick to adapt to these changes—the marketplace exacts severe penalties if they do not. Improved competition among markets has lowered capital costs for issuers and increased returns for investors.

Moreover, the preeminence of U.S. markets is no longer assured. Buyers and sellers of capital can access markets around the globe, in both established markets such as New York, London and Tokyo, as well as nascent markets such as Malaysia. Along with market depth, cost and quality of regulation are key competitive factors.

Past experience has demonstrated how quickly foreign markets are willing, and able, to capitalize on overregulation in the United States. In the 1960s, Congress enacted the Interest Equalization Tax, which imposed a 30 percent withholding tax on interest paid on bonds sold in the U.S. to foreign investors. While this tax did produce some short-term revenue gains for the federal treasury, more importantly, it served as a catalyst for the development of the Eurobond market. Despite later repeal of the legislation, this market has remained overseas.[29]

In some respects, U.S. markets already are being usurped. For example, the case can be made that London is the leading *international* capital market, with 464 foreign issuers listed on the London Stock Exchange with aggregate market capitalization of over $3 trillion (compared with fewer than 300 on the NYSE with market capitalization of just over $200 billion),[30] despite the fact that it has a relatively small domestic capital base. London is also the leading foreign exchange market with daily trading volume exceeding New York and Tokyo combined.[31]

While I believe that the U.S. capital markets will continue to be the market of choice for U.S. and some foreign issuers for the foreseeable future, we must be careful to recognize and respond to the changing marketplace environment to ensure the continued health and vibrancy of U.S. markets.

PRINCIPLES FOR REGULATING CAPITAL MARKETS

From a broader perspective, as markets move into the 21st century, we can ill afford a regulatory system based on outmoded constructs and principles. Previously, the issue of high cost regulation was not an important consideration—in a domestic, insular market environment, participants had little choice but to adhere to the edicts of the SEC. However, the global financial arena is now distinguished by fierce competition among markets that service buyers and sellers of capital worldwide. Market participants are more willing, and able, to move to other, less onerous regulatory regimes.[32] Moreover, market participants now are able to create substitutes

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[28] See, e.g., Andrew Freeman, "The Future of Finance: Capitalism Without Owners?" and David Folkerts-Landau and Alfred Steinherr, "The Wild Beast of Derivatives," Finance and International Economy, ed. by Richard O'Brien (Oxford University Press 1994).

[29] See, e.g., Eugene Sarver, *The Eurocurrency Market Handbook* (New York Institute of Finance 1990), pp. 33-34; Gunter Dofey, "The Eurobond Market: Function and Future," *International Business Series* No. 7 (1969), pp. 25-29.

[30] See *Wall Street Journal*, September 29, 1995, p. A20: New York Stock Exchange Research Report, September 1995.

[31] Robert Chote, "London keeps forex supremacy," *Financial Times* (September 20, 1995) p. 1.

[32] See Joseph A. Grundfest, "Zen and the Art of Securities Regulation," in Kenneth Lehn and Robert Kamphuis, eds., *Modernizing US Securities Regulation: Economic and Legal Perspectives* (Pittsburgh, PA: The Center for Research on Contracts and the Structure of Enterprise, Univ. of Pittsburgh, December 1992), p. 4.

for products and transactions that are not subject to the jurisdiction of regulators and to create synthetic exposure to virtually any market or definable risk.

If U.S. markets and market participants are to maintain their preeminent position, a balanced approach to regulating capital markets that takes into consideration the needs of both buyers and sellers of capital is necessary. This approach should reflect the way markets now operate and be flexible and anticipatory enough to accommodate future developments. This will require policymakers to "step outside the box" and rethink both the way markets function and what constitutes an optimal regulatory paradigm.

This entails not only a review of existing laws and regulations to identify those that are duplicative and unnecessary, but also a reexamination of regulatory *structure*, and perhaps most importantly, the *approach* to regulation. Where regulation is cost-effective, properly balancing investor protection, efficiency and competition concerns, markets will thrive. Where regulation imposes costly and unnecessary barriers to capital formation, markets will whither and die. There must be a balance between an appropriate regulatory framework and the conditions necessary to foster capital formation. Within this construct, the proper role of the regulator in today's markets is to balance the demands of suppliers and users of capital.

Regulatory Predicates

Although it often seems otherwise, it is not the purpose of capital markets to beget regulation. Yet, there clearly are market failures that warrant some measure of regulatory intervention, particularly where there are negative externalities or information asymmetry. For example, the negative externalities associated with the failure of one or more financial institutions could threaten the safety of the financial system as a whole, and thus justifies regulation at the firm level. In the past, regulators were most concerned with the danger of a massive run on banks. A greater concern now rests with the possibility that a Barings-type failure could bring down the entire financial system. The asymmetric information problem exists principally at the retail level, where individuals may be purchasing products issued and distributed by firms far more knowledgeable and sophisticated than they are.

It is the purpose of capital markets to facilitate the flow of capital from suppliers to users, from investors to businesses. Prior to enacting a regulation, therefore, the regulator should first make a compelling case that regulation is necessary and appropriate to address the identified concern. Just as markets sometimes fail, regulation also can be imperfect. A specific line of inquiry should precede any regulatory initiative:

- *What is the specific governmental interest in regulating a particular activity, transaction, or organization and is it sufficient to warrant regulation?* It is not enough merely to assert a governmental interest; it should be suitably demonstrated. For example, some commentators argue that legislation should be passed to regulate the sale and use of derivatives. What is the governmental interest? Is it to protect investors? Is it to protect against systemic failure? Derivative financial products are used primarily by institutional investors and professional speculators who neither need, nor want, the protections afforded by the federal securities laws (above and beyond the anti-fraud provisions). With regard to systemic risk concerns, how is systemic risk defined, and, more importantly, what empirical evidence is there that transactions in derivatives are likely to lead to a systemic crisis? Moreover, would efforts to regulate derivatives domestically merely succeed in forcing business offshore without addressing systemic failure dangers?
- *Can or do market forces effectively self-regulate and adequately protect the integrity of the markets?* Clearly, there are examples of market failure, some of which are spectacularly costly. Market failures do occasionally impose significant costs upon market participants. By the same token, history shows us that markets generally are self-correcting. Again, recent experiences with derivatives are illustrative. For example, the Barings failure resulted from a serious lapse in internal controls, prompting a reevaluation of risk-management controls across the industry that has almost certainly lessened the prospect for another failure of similar magnitude—without any new regulation.
- *In those instances where regulation is appropriate, is the form and substance of regulation cost effective and is it the minimum necessary to achieve the regulatory objective?* In this regard, it is critical to consider not only the regulation at issue, but the aggregate weight of regulation. While a specific new regulation may be appropriate, and not appear to be particularly costly, combined with other seemingly innocuous regulations it may become overly burdensome. Regulators must calibrate their market interventions to specific market failures, and seek to avoid regulatory overkill.

Regulatory Principles

Regulatory policy is too frequently made on an ad hoc basis without regard for the larger implications of the policy. Regulation must be considered in the context of its overall impact on capital markets and market participants. In this regard:

- *Regulation should facilitate capital formation, not impede it.* However basic, this is the most fundamental regulatory principle. By nature, regulation imposes costs on the regulated. Nonetheless, some level of regulation is beneficial and fosters the process of capital formation. A well designed and administered regulatory system instills investor confidence, preserves a broad public interest in efficient markets, and safeguards against fraud and misconduct. Unregulated, or poorly regulated, markets have not been as successful in attracting investors as have U.S. markets. Most investors will demand certain protections before committing their savings to a particular market. Yet, a market characterized by regulatory overreach dissuades issuers by raising the cost of capital beyond what would allow an optimal rate of return. In short, overregulation prices participants out of the market.
- *Regulation should strike a balance among often competing goals and objectives.* The SEC's traditional mandate has been to protect investors. The banking regulator's principal concern has been the safety and soundness of the banking system. The CFTC has had more of a market efficiency orientation. Overreliance on one policy approach may come at the expense of other considerations. For example, the banking regulators insistence on the confidentiality of bank examinations for safety and soundness reasons detracts from both market efficiency and investor protection. Each financial regulator should be statutorily required to balance investor protection, systemic risk, market efficiency and competition concerns. Striking the proper balance between the needs of investors and the needs of issuers should be the primary role of regulators in today's markets.
- *Regulation should be integrated and integrative.* The regulatory scheme for financial markets is a morass of federal statutes and rules, interpretative releases, no-action letters, self-regulatory strictures, state banking and securities laws, state corporate laws, tax laws, and international trade agreements. Consideration should be given to integrating the federal securities law statutes into a single comprehensive and cohesive statutory body, as originally proposed by the American Law Institute. Legislative provisions and regulations that are unnecessary, duplicative, or contradictory should be eliminated. From a domestic perspective, the legal and regulatory standards of the cash and derivative markets should be integrated or harmonized, and, as discussed below, there should be a more rational division of responsibility between federal and state regulators. It is increasingly important that legal and regulatory standards of the developed capital markets—particularly in the accounting and clearance and settlement areas—be harmonized.
- *Regulation should provide clarity and certainty to market participants.*[33] In many cases, regulation, by design, engenders confusion among market participants as to what conduct is and is not permissible. This succeeds only in forcing market participants to retain legions of specialized lawyers to render legal opinions or to obtain no-action letters, and often generates needless litigation. A disturbing manifestation of this problem is the tendency of regulators to regulate by prosecution. Instead of promulgating an understandable rule or issuing an interpretative release clearly spelling out parameters of conduct, regulators wait for an opportunity to commence an enforcement proceeding and deliver a "message" to market participants.
- *Regulation should be based on performance standards, not command and control edicts.*[34] Too much regulation entails micro management and proscriptions against activities that potentially may be abusive. Market participants should be given latitude to conduct business in a manner dictated by economic considerations. By the same token, when market participants step over clearly delineated lines, it should be understood that the regulators will prosecute transgressions vigorously.

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[33] In his valedictory speech upon leaving the SEC, former Commissioner Edward Fleischman stressed the importance of providing clarity and certainty and the regulated community, Fleischman, "Dear Mr. President: . . ." Remarks to the Securities Law Luncheon Group (March 25, 1992).

[34] *Ibid*

It is interesting to observe that several press stories have described the provisions of H.R. 2131 as radical and unprecedented.[35] While reasonable minds may disagree as to the merits of each of the bill's provisions, the fact is, as noted below, most of them have been the subject of considerable debate and discussion for many years. I would like to focus on a few of the bill's important provisions:

Suitability

Section 2 of the bill would preclude the application of SRO suitability rules for the investment decisions of institutional investors and would establish an express presumption in private suits that broker-dealers are not responsible for investment recommendations made to institutional clients, unless the parties have entered into a contract to the contrary. It would define the term institutional client to mean all investors other than natural persons, with $10 million or more in investments.

The suitability issue, particularly as it relates to institutional investors, has recently come to the fore as the result of several high-profile instances of large losses by institutional investors. This is a particularly muddled area of the law right now,[36] and I applaud the Committee's efforts to provide some needed clarity and certainty on this subject.

In ordinary circumstances, the law generally assumes that the parties to a commercial arms length transaction are able to look after their own interests. On the other hand, where there is what economists call "information asymmetry"—where one party to a transaction has an inherent informational advantage, then some additional layer of regulation of the transaction may be warranted. In the case of broker-dealers and retail investors, the concept of suitability is a reasonable one. However, in the context of a broker-dealer and a professional money manager, this policy is less compelling.

The bottom line is that broker-dealers should not be made to be guarantors for the investment decisions of clients. Markets are by nature risky. So long as investors are provided with sufficient, accurate information regarding the risks associated with an investment product, they should bear both the gains and losses resulting from their investment decisions. Moreover, the federal securities laws were never intended to protect those who are able to fend for themselves.[37] Whether managing $10 million is an appropriate indication of knowledge and sophistication is an open question—it would at least seem to be in the ballpark. Ultimately, it is incumbent on those who professionally manage money on the behalf of others to fully understand the nature of the risks associated with the financial products in their investment portfolios—in fact, they have a fiduciary obligation to invest managed funds in a prudent fashion.

By the same token, vigorous enforcement action should be taken against any broker-dealer that misleads a client, institutional or retail, or misrepresents the nature of an investment product and the risk associated with it.

State Securities Laws

Section 3 of H.R. 2131 would largely preempt state laws with respect to the registration of securities offerings, broker-dealer registration and regulation, and the regulation of investment advisers. States could continue to require notice filings, assess filing fees, enforce federal standards, and require the registration of securities professionals through a central registry system. The effective result of these provisions would be to move toward a uniform national standard of securities regulation.

In an era of national and transnational securities markets, it is absolutely imperative that we devise a more rational, responsible division of authority between federal and state securities regulators. That is not to say that states should not have a role in securities regulation. Indeed, given the limited resources of the Securities and Exchange Commission, it is critically important that the states continue to play a role in regulating certain securities markets activities and professionals. SEC Chairman Arthur Levitt set exactly the right tone for constructive debate on these issues in his recent remarks to the North American Securities Administrators Asso-

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[35] See, e.g., R. Lowenstein, "House Aims to Fix Securities Law, But, Indeed, Is the System Broke," *Wall Street Journal* (1995); "GOP Securities Law Plan May Tilt Balance of Power" *Wall Street Journal* (July 28, 1995), p. C1.

[36] See, e.g., *Minneapolis Employees Retirement Fund v. Allison-Williams Company*, 519 N.W. 2d 176 (Minn. 1994); *West Virginia v. Morgan Stanley & Co., Inc.*, No. 22358 Sup.Ct.W.Va. (June 5, 1995), *City of San Jose v. Paine, Webber, Jackson & Curtis*, 1991 WL 352485 (N.D. Cal.); and *M&B Contracting Corp. v. Dale*, 601 F. Supp. 1106 (E.D.Mich 1984).

[37] *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

ciation. I would note that NASAA itself has recognized the need for better line drawing and has established a new task force on state-federal regulation.

Generally speaking, those activities that are predominately national (or international) in scope and character should be regulated at the federal level. States should be responsible for those activities and persons that are essentially local. In addition, in order to ensure that there are enough "cops on the beat," states should have a role in enforcing a single set of national regulatory standards. The question is one of balance. Under the present system, there is too much duplicative and unnecessary regulation at the state level. By the same token, the SEC has responsibility for some activities and persons that would be better handled by the states.

With respect to securities offerings, it should be noted that as of the beginning of 1996, an issuer will be able to raise capital throughout the European Community by complying with a single set of regulatory requirements. Both domestic and foreign issuers should be able to raise capital in the U.S. by relying on just one set of regulatory requirements. As SEC Chairman Levitt noted in his recent speech to NASAA, "to force American firms to cope with a regulatory jigsaw puzzle with each new offering or product, is to saddle them with a competitive disadvantage in the global marketplace."[38]

While the states have exempted from blue sky regulation issuers that are listed on an exchange or the NASDAQ, it would nonetheless be appropriate to preempt existing state registration requirements, or at least codify the existing exemptions into federal law. Generally speaking, it appears that H.R. 2131 takes a reasonable, middle-of-the-road approach to resolution of this controversial issue. Rather than wholly preempting state authority in this area, the bill would preserve state jurisdiction with regard to wholly intrastate and blank check offerings and would enable states to require notice filings and pay registration fees.

State regulation of investment companies is particularly problematic and unduly burdensome. In its detailed study of investment company regulation, the SEC noted that "the diversity of each state's substantive and procedural blue sky requirements make compliance difficult."[39] Given the comprehensive and substantive nature of regulation of investment companies at the federal level, there is virtually no justification for an additional layer of regulation at the federal level. The approach taken in H.R. 2131 seems eminently reasonable.

In contrast, I would argue that a compelling case can be made for a significant role for states in the regulation of investment advisers. The fact is that the majority of the more than 20,000 persons registered under the Investment Advisers Act of 1940 have fewer than fifteen clients or no assets under management. The SEC simply lacks the resources to provide any meaningful oversight of these persons, and, more importantly, it is difficult to discern a compelling federal interest in regulating the activities of these persons. The states, on the other hand, would be well positioned to provide oversight in this area. Larger investment advisers should be exclusively regulated by the SEC. Legislation introduced in the Senate by Senator Gramm—S. 148, the "Investment Advisers Integrity Act"—is an approach that warrants serious consideration. At the very least, I would recommend revising section 203(b)(3) of the Investment Advisers Act to strike the holding out clause. Consideration should also be given to the establishment of an SRO for investment advisers.

While a case can be made for some level of state regulation of securities professionals, the current system is unduly complicated and burdensome. SEC Chairman Levitt recently noted that a brokerage firm was subjected to 15 sets of securities examiners in the span of just 24 months.[40]

Margin Requirements

Section 4 of H.R. 2131 would significantly revise existing securities margins requirements to, in large part, reflect the increasing institutionalization of markets. Among other things, the bill exempts certain institutions from the margin provisions, prohibits the exchanges and the NASD from imposing margin requirements that are different from those imposed by the Federal Reserve, eliminates margin requirements for all debt securities, and exempts "excluded accounts" from section 11(d) of the Exchange Act.

There is widespread agreement on the need to revise current margin regulations but not on the way in which they should be revised. The introduction of this legisla-

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[38] Remarks of Arthur Levitt to the North American Securities Administrators Association, October 23, 1995.

[39] "Protecting Investors: A Half Century of Investment Company Regulation," *SEC Division of Investment Management* (May 1992), p. 217.

[40] Remarks of Arthur Levitt to the North American Securities Administrators Association, October 23, 1995.

tion has led the SEC to submit a more modest legislative proposal resulting from an agreement reached with three major Wall Street firms. However, as you know from the testimony of Federal Reserve Chairman Alan Greenspan last week, the Board does not believe that the Commission's proposal goes far enough and recommends repeal of both section 7 and subsection 8(a) of the Exchange Act, leaving federal oversight of securities credit extensions by broker-dealers to the SEC and SROs.

While I am not in a position to make a judgment as to the best course of action in this area, I think it is appropriate to inquire whether any margin rules are necessary in global, institutional markets, such as the fixed-income market. This is an intensely competitive market and disparities in regulatory treatment can readily translate into higher costs and lost business. A level playing field for all providers of securities credit, from both domestic and international perspectives, should be the basic policy objective. It would also seem that individual financial institutions would be best positioned to determine what their credit risks should be in the context of their overall risk exposure, and to protect themselves accordingly—a one size fits all approach could be counterproductive.

Williams Act provisions

Section 5 of H.R. 2131 would amend the Exchange Act to repeal several provisions that govern tender offers and the beneficial ownership of securities, collectively referred to as the Williams Act, particularly sections 13(d) and (e) and sections 14(d), (f), and (g).

Mr. Chairman, I must confess to some ambivalence about these provisions of H.R. 2131. I would note that a number of academics (and academic studies) have concluded that the Williams Act is not, as it was intended to be, neutral as between bidders and targets and that the operation of the rules shifts gains from active to passive shareholders.[41] I am also concerned that the Williams Act provisions have resulted in overly substantive regulation of third-party tender offers.

Nonetheless, I am not sanguine about the likelihood that the approach taken in H.R. 2131 would represent an improvement over existing law. In particular, allowing states to regulate in this area could result in a significant impairment of the market for corporate control, lessen shareholder profit opportunities, and insulate managements from the discipline of the marketplace. While the competition among states with respect to corporate governance laws generally has been quite constructive, the incentives for responsible action in the area of corporate control are lacking. States have demonstrated a willingness to adopt new laws virtually overnight to protect the interests of domestic companies. This kind of ad hoc legislating is not conducive to good public policy.

Prospectus Delivery

Section 6 of H.R. 2131 would permit confirmations of sales to be mailed without accompanying prospectuses and securities to be delivered to a customer without a prospectus (unless the investor has specifically requested the prospectus).

I strongly support revision of the prospectus delivery requirements of the Securities Act, particularly the requirement that a final prospectus accompany confirmation. It is apparent that the final prospectus has virtually no bearing on an investor's investment decision. Moreover, with advances in communications capabilities, the mandated dissemination of paper documents will become increasingly anachronistic and wasteful. It is interesting to note that this topic was addressed by Milton Cohen, chair of the Special Study, in his seminal article, "Truth in Securities Revisited," in the *Harvard Law Review* nearly 30 years ago.[42]

Cohen raises a number of issues that have particular relevance in today's market. For example, he notes that when an investor has seen a statutory prospectus for the first time upon confirmation of the sale, "he hardly can be said to have derived benefit from the affirmative aspect of the prospectus delivery requirement..."[43] He also notes that prospectuses generally are read by a "relatively small number of professionals or highly sophisticated nonprofessionals" but not "by the great majority of those investors who are not sophisticated" and concludes that the delivery requirement should not be "regarded as a more sacred cow than it really is."[44] Finally, and perhaps most importantly, he states that "physical delivery is not essential to dissemination of information" as the "best and strongest research and ana-

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[41] See, e.g., Gregg Jarrell and Michael Bradley, "The Economic Effects of State and Federal Regulations of Cash Tender Offers," *The Journal of Law and Economics* Vol. 23 (1980).

[42] Ulton H. Cohen, "Truth in Securities Revisited." 79 *Harvard L. Rev.* 1340 (1966).

[43] *Ibid* p. 1351.

[44] *Ibid* p. 1352.

lytic facilities of the financial community will reach it, use it, and in some form and degree disseminate it."[45] This, of course, was before what was to become the Internet was even a gleam in the eye of the Defense Department.

Finally, three decades later, there appears to be general agreement that the prospectus delivery requirements should be updated. The SEC recently issued a very thoughtful interpretive release and companion rule proposal intended to facilitate the electronic dissemination of prospectuses and related materials,[46] although the Commission's proposal does not go far enough although the exemptive authority provided in the bill would enable the Commission to take the next step.

Exemptive Authority

Section 7 of H.R. 2131 gives the SEC broad exemptive authority under the Securities Exchange Act (and specifically would raise the exemption for small offerings to $15 million). I strongly support this provision of the bill, but would also provide comparable authority under the Exchange Act. It should be noted that the Investment Company and Investment Advisers Acts already provide the Commission with broad exemptive authority. It makes little sense not to extend the exemptive authority to the Exchange Act, as well.

The SEC's Statutory Mission

Section 8 of H.R. 2131 would amend each of the federal securities statutes to require the SEC to take into account efficiency, competition, and capital formation concerns when considering any agency action.

As may be gleaned from my discussion of appropriate regulatory principles, this is perhaps the most important provision in H.R. 2131. The provision in the bill is not only reasonable, but entirely appropriate given the dynamic, global nature of today's financial markets. The issue is not what *is* the SEC's principal statutory mandate under current law, but rather, *what should it be.* Without question, protecting the interests of investors is vitally important to ensuring their continued faith and confidence in the integrity of markets and I am not advocating any dimunition in investor protection standards. But, it is important to recognize that investor protection is only a means to an end, not and end itself. Moreover, the SEC should not be just a consumer protection agency. The nature of today's markets demands that it also consider the impact of its actions on the efficiency of markets and the competitive posture of the markets and market participants.

While the Commission has been a good steward of our securities markets, it too often has given only passing consideration to other policy objectives and costs of proposed regulations.[47] The Commission rarely engages in a rigorous cost-benefit analysis prior to proposing rule changes, and statutes such as the Regulatory Flexibility Act and Paperwork Reduction Act are sometimes given superficial attention even in rule proposals that likely would have a substantial impact on market functions. A prime example is the SEC's recently proposed order execution rule proposal.[48] Aside from the substantive issues raised by the rule proposal, the proposed rules could fundamentally alter the nature of trading markets and have profound implications for the future of dealer markets and proprietary trading systems. Yet while the Commission has requested comment on the effects of competition and the costs of the proposed rules, it does not appear as if the Commission has examined these issues in any detail itself.

As President Roosevelt noted in his letter to Congress proposing legislation that would become the Securities Act of 1933, "The purpose of this legislation...is to protect the public with the least possible interference with honest business."[49] What was true then is even more important today. Statutorily requiring the Commission to balance investor protection, efficiency and competition concerns is clearly warranted.

Number of Commissioners

Section 9 of H.R. 2131 would reduce the number of SEC commissioners from five to three. Based upon my experience serving as counsel to a SEC commissioner, I believe that the Commission's workload is such that reducing the number of commissioners would likely slow down regulatory processes and end up costing more than might be saved through the elimination of two offices.

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[45] *Ibid.*
[46] SEC Rel. No. 33-7233 and 34-7233 (October 13, 1995).
[47] See Grundfest p. 8.
[48] SEC Rel. No. 34-3610; File No. S7-30-95 (September 29, 1995).
[49] Letter from President Roosevelt to the Congress, Cong. Rec. 937 (March 29, 1933).

Repeal of the Trust Indenture Act

Section 14 of H.R. 2131 would repeal the Trust Indenture Act. While the Act was streamlined as a result of legislation in 1990, it is clear that the requirement that an indenture agreement be completed and a trustee appointed for each and every debt offering is unnecessary and costly. On the other hand, in those rare instances where there is a default, the debt holders interests are better protected by having an independent trustee represent their interest. A much more limited Act, requiring an indenture and appointment of a qualifying trustee in the event of default or bankruptcy proceeding, would seem to make sense.

ADDITIONAL REFORMS

Mr. Chairman, as important as are the issues you raise in H.R. 2131, I believe they represent only part of a broader reexamination of the federal securities laws and necessary legislative changes. In this regard, let me note that I strongly support the bill that you and Rep. Markey have introduced, H.R. 1495, to update and modernize the Investment Company Act. I would also urge you to consider repeal of the Public Utility Holding Company Act, as the SEC has recommended, assuming that other related energy policy issues can be resolved. In addition, as the pace of global securities offerings accelerates, it is increasingly imperative that we harmonize cross-border offering and listing standards. Of particular importance is the development of some form of internationally acceptable accounting standards. Finally, although legislation may not be required, I would commend to you the important work of the SEC's Advisory Committee on Capital Formation and Regulatory Processes, chaired by Commissioner Steve Wallman, and their efforts to implement a company registration model.

CONCLUSION

Mr. Chairman, we are fortunate to have securities markets of unparalleled depth and quality. We should do all we can to ensure that the strength, integrity and competitive position of securities markets is not only maintained, but enhanced. A comprehensive review of the existing statutory and regulatory framework, followed by appropriate regulatory and legislative changes, is necessary to the achievement of that goal. H.R. 2131, and the debate that it has engendered, is a critical part of the process.

Mr. FIELDS. Thank you, Mr. Belt.

The Chair apologizes for having to be out of the room for a moment.

But I understand, Mr. Sargent, you testified relative to the Federal-State relationship and earlier today one of our members referred to a report by the Pennsylvania Securities Administrator that suggested that State blue sky regulation does not impose significant burdens on the market, and noted that only 5 percent of all SEC filings were subject to review by the Pennsylvania Securities Commission.

Do you think that statistic demonstrates that State regulation of securities does not impose a significant burden and, if not, why not?

Mr. SARGENT. Well, I do not think it demonstrates that point. And I thank you for the opportunity to reiterate my views on this question.

One key point to remember about Pennsylvania is that I believe they do not register investment companies, unlike the vast majority of other States. The blue chip—blue chip marketplace exchange listed exempts, whatever you want to call it, does not apply to investment companies. Investment companies are required to register their offerings in most of the States. And so if there is a problem with State regulation of investment companies, it is not solved by that exemption.

There is also a question as to whether the existing consensus about the States having marketplace exemptions will hold. There was a tremendous battle in the 1980's to persuade the States, over considerable opposition from the States, to adopt this approach, and it is by no means clear that this approach will stay in forever. Many of these exemptions have been adopted only by rule and not by statute, so they can be removed through a rulemaking process.

In addition, some States may add on additional requirements to their marketplace exemption, which may make it difficult to consummate deals even though you have these basic exemptions. Even if only 5 to 10 percent of the offerings in a given State are subject to the full scale of State registration requirements, that is not trivial for those deals and we can't assume that all of those deals are deals that need this type of State regulation. So the phenomenon in Pennsylvania just indicates that we have a somewhat less serious problem than we did 5 or 10 years ago but that we still have a serious problem.

Mr. FIELDS. And, again, I guess the point to be made is that you have a multiplicity of how these laws were applied, that in and of itself is part of the problem. It leads to the figures that I quoted just a moment ago from the CRS

Mr. SARGENT. Absolutely.

In an area which no one really has mentioned, which I think is even more problematic, is State regulation of offerings exempted at the Federal level, exempted under Regulation D or some other similar exemption. The States require either registration or separate exemption of those offerings in each of the States. Many States apply what is called a "Uniform Limited Offering Exemption," but which is by no means uniform.

And I think using the word—the phrase "patchwork quilt" to describe it is far too generous. A patchwork quilt could be kind of benign, kind of attractive. When you are talking about State regulation of exempted offerings, you are talking about a "Kafkaesque" situation, where you have variations from State to State in how many purchasers you can have, how many offerees you can have, how you can conduct your offer and what you have to disclose, what disqualifications exist.

Mr. FIELDS. Mr. McDaniel, let me ask you, on page 2 of your testimony, you state that a trustee does very little. What is the purpose of a trustee and why is it?

Mr. MCDANIEL. Originally, back in the thirties, there were a lot of bondholders spread across a large number of States, and in those days, bonds were typically issued as bear bonds so nobody knew exactly who they were. So one of the principal ideas of having a trustee is since you couldn't find the bondholders, you didn't know who they were or where they were, you needed somebody to come forward and say something on their behalf, but those days are long behind us.

Bondholders today are large institutions and, in fact, the bond market is even more institutional than the stock market and bear bonds, the IRS took care of them and tossed them out because too many people are trying to escape taxes by taking bear bonds. So that issue is really a piece of ancient history. So, today, you don't need a trustee in the way you did maybe 50, 60 years ago.

Mr. FIELDS. So what is the purpose of the trustee today?

Mr. MCDANIEL. Honestly, in my view, today, about all a trustee today does is sort of a super executive secretary. They sit in bankruptcy proceedings. They can't vote because they don't have an investment. They sit there. They take notes.

They report back to the bondholders and write them letters and then often ask the bondholders: Well, what do you want me to do? And since the bondholders may write back and have different views on that, the trustee is often—get sort of frozen into inertia and they don't do much of anything. I think they are supernumerary, and this act, of all the statutes you have all been talking about, is really something that belongs in the dust bin of history.

Mr. FIELDS. Well, are you saying, in addition to it being antiquated, is there a cost factor to it? Or is it just bureaucratic in the process?

Mr. MCDANIEL. Well, it is both. There is a cost factor because you are asking companies, when they accelerate a bond offering, to hire a trustee. You have got to do that, whether you want to or not. Whether anybody wants one or not, you have to pay for a trustee. So it seems to me a rather——

Mr. FIELDS. What was an example of a cost?

Mr. MCDANIEL. It is not a lot for any one issuer, but say, for a large bond issue, it could be $5,000 or $10,000. But you multiply that over a lot of issues, over a lot of years and you get to pretty big numbers.

Plus, there are the additional costs of when you get into bankruptcy, somebody has got to pay these trustees to perform their functionary role, and I don't know what those costs are, but they are just more people sitting at the table generating more paper, running up the cost of bankruptcy. What those costs are, I would not begin to guess.

Mr. FIELDS. You also explained that the trustee often resigns in the case of a default.

Mr. MCDANIEL. That is——

Mr. FIELDS. The question is, doesn't that defeat the purpose of having a trustee?

Mr. MCDANIEL. Yes, it does; doesn't it?

Well, the reason that comes up is that corporations tend to want to hire a trustee, they think they are doing the bank a favor by hiring the same bank as trustee that lends them money, so when the company goes into default, the usual case is the bank is the lender of that company. So the bank says, well, look we have got a conflict here. I have got to quit. So then you have to go out and get a replacement trustee.

In fact, there is a little business; there are two or three banks in the United States that sort of go around and take on these—this somewhat unpleasant job. I guess they are able to make some money out of it. But the whole thing is sort of a—it is kind of a Rube Goldberg invention, that what you see is not what you get. And that is why they resign.

Mr. FIELDS. The Chair's time has expired.

The gentleman from Pennsylvania, Mr. Klink.

Mr. KLINK. Thank you very much, Mr. Chairman.

Mr. Sargent, let me just start, since I am the bandit from Pennsylvania that made the comment a little earlier; if I understand your comments in response to the Chairman's question, are you saying that if all States didn't review mutual funds, as Pennsylvania does not review mutual funds, that the problem effectively would go away?

Mr. SARGENT. That is right. If the States did not review investment companies, either by virtue of Federal preemption or a decision on the part of the States to adopt a blue chip exemption, or at least some kind of exemption for investment companies, then we wouldn't have a duplicative set of regulations with respect to investment companies.

Mr. KLINK. So we are doing something right in Pennsylvania.

Mr. SARGENT. Absolutely.

Mr. KLINK. I will let Mr. Lam know how highly you think of him.

Mr. SARGENT. He wouldn't believe you.

Mr. KLINK. Mr. Belt, I was interested in reading through your prepared statement, at page 30 of your written statement, you state that Section 8, "is perhaps the most important provision of H.R. 2131." The foremost mission of the SEC is investor protection.

Section 8 would require the SEC to consider or determine whether its actions will promote efficiency, whether it will promote competition and capital formation, whenever the SEC is required to consider or to determine if that action is consistent with the public interest and the protection of investors or both.

Last week, the SEC testified before this subcommittee that existing law already requires it to give consideration to efficiency, to competition and to capital formation, and to do a cost/benefit analysis when it proposes or adopts its rules. The SEC raised grave concerns about the impact of Section 8 on enforcement actions and adjudicated opinions, stating that, to quote from them, "The Commission would oppose legislation that would mandate such an analysis in those context." Mr. Belt, your own regulatory principles, page 19, recognizes the importance of well-administered safeguards against fraud and misconduct. Do you agree or disagree with the SEC's concerns about Section 8?

Mr. BELT. Mr. Klink, I would like to make several points. First and foremost, my testimony refers to the need to apply these concepts with respect to agency rulemakings. That would not necessarily be the case in adjudicated matters. That is first.

Second, with respect to the Commission's—the existing requirements applying to the Commission, for example, the idea that they need to consider competition arises only in Section 23, I believe, of the Securities and Exchange Act. It does not apply across all securities acts as the legislation would.

They also do give some consideration to cost/benefit analysis, but that is something that is not required by law and statute.

I would simply draw to your attention, and I think I mentioned this in my prepared remarks, a recent rule proposal put out by the Securities and Exchange Commission dealing with best execution. It is a 100-page rule proposal.

Apart from the merits of the rule proposal, and we don't need to get into that, it is generally recognized it would have profound implications on the nature of securities markets and trading markets

in the years ahead, particularly with respect to the innovation and development of new trading systems like proprietary trading systems.

You can look, for example, at page 74 of that release, where the Commission has a Section entitled, "Effects on Competition," noting that, in fact, Section 23(a) of the Exchange Act requires the Commission to look at the effective competition under the 1938 Act.

Their conclusion with respect to the effect on competition is basically one sentence: The Commission preliminarily views the proposed amendments as causing no burden on competition, unnecessary or inappropriate, in furtherance of the purpose of the Act—with no discussion whatsoever of the underlying basis for that conclusion; no discussion or quantification of the cost or benefits at all.

I think it is incumbent upon a regulatory body in proposing and adopting rules that are going to have a profound impact on markets and market participants, to have some firm understanding of what the effects will be, not only with respect to investor protection, but since we exist in a global competitive, dynamic marketplace, what the effects will also be on the efficiency of markets and on competition at large.

Mr. KLINK. Well, we are obviously concerned about both of those things, efficiency in competition and raising capital.

My question—you know, we always tend, I guess, to look at the extremes, because when we pass a law or don't pass a law, we hear about the extreme side of these issues. I suppose what I want to get to is: What impact would the analysis mandated by Section 8 of this bill have had on the imposition of sanctions on people like Ivan Boesky and Michael Milken?

If the SEC determined, for example, that Milken's activities really aided in capital formation, would they, under this bill, be able to take adequate enforcement actions against him for what he was ultimately found guilty of?

Mr. BELT. Again, Mr. Klink, I—my recommendation is to only apply these concepts in a rulemaking context, not in an adjudicative context.

The second point I would mention—and that is something that would have to be determined by the SEC after notice and comment—is that if a particular course of action from a regulatory standpoint, they determined that the cost exceeded the benefits, applied to the markets as a whole, then, in fact, it would be my view that they should not go forward with that particular rulemaking.

Mr. KLINK. Okay.

If I could, Mr. Chairman, just—I am told by counsel, Securities and Exchange Act of 1934 under 23(a)(2), "the Commissioner and the Secretary of the Treasury in making rules and regulations pursuant to any provisions of the title shall consider among the matters the impact any such rule or regulation would have on competition," and it goes on from there. "The Commission and the Secretary of Treasury shall not adopt any such rule and regulation which would impose a burden on competition not necessarily appropriate in the furtherances of the purposes of this title." It goes on from there.

Mr. BELT. Yes. I had referred to Section 23. Yes.

Mr. KLINK. Thank you.

I yield back, Mr. Chairman.

Mr. FIELDS. The Chair wants to thank our panel.

There may be additional questions that we would want to submit in writing. We would appreciate your prompt response if that happens.

Thank you very much.

The Chair, you understand, Mr. Fleischman may have a time conflict, so we are going to go ahead and proceed.

Mr. Dee Harris, President of North American Securities Administrators Association.

Mr. Harris.

STATEMENTS OF DEE R. HARRIS, PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION; MARK J. SALADINO, REPRESENTING GOVERNMENT FINANCE OFFICERS ASSOCIATION; AND EDWARD H. FLEISCHMAN, CONSULTANT, LINKLATERS & PAINES;

Mr. HARRIS. Mr. Chairman and members of the subcommittee, NASAA appreciates the opportunity to appear before you today and to testify regarding State regulation of securities.

H.R. 2131 represents an opportunity for a dialog about modernization of securities regulation in the United States. During the dialog, it may be possible to find ways to reduce regulatory burdens without reducing investor protection and investor confidence.

State security administrators know that their diligent efforts add value to one important component of the total regulatory system in the United States. We are proud of what we do, but we are quite open to evaluation and we are willing to evolve, if appropriate. Indeed, State securities regulation has steadily evolved over at least the last 20 years.

The dialog has already produced one tangible product; the MOU on broker/dealer examinations which Chairman Levitt described during his testimony before this subcommittee last week.

In addition, as you know, NASAA has appointed a distinguished task force of industry executives, lawyers, academics and regulators to, among other things, study the optimum allocation of resources by the applicable State and Federal agencies. The task force held its first meeting last week, expects to meet regularly and conclude its work as speedily as possible.

We have provided the written materials from the first meeting to the committee staff and we will continue to do so with respect to future meetings.

Also, as the newly installed president of NASAA, I have appointed several special committees which may be of interest to you. One committee will undertake a complete review of the Uniform Securities Act. Another will attempt to devise a uniform private placement exemption which would make it easier to coordinate a multi-State private offering.

A third committee will seek to devise appropriate regulatory responses to both legitimate and fraudulent offerings on the Internet. Other special committees are working on other issues.

Mr. Chairman and members of the subcommittee, it is clear that State securities officials must redouble their efforts to explain what

they do and what they do not do. That is why the opportunity to appear here today is of such value to State regulators and the public we serve.

Much has been made of the process of State registration of securities offerings. Some have even suggested that the process inhibits national and international securities offerings. If that were true, that would be cause for corrective action.

However, as the numbers compiled by the State of Pennsylvania as set forth in my written statement indicate, this is not true. For the most part, national and international offerings are exempt from State registration requirements. National and international offerings which are not exempt do get registered, and I can say from my personal experience of participating in the process on both sides of the table for 23 years, that things usually go reasonably smoothly. Most of the national offerings which are not exempt from State review are investment companies.

NASAA is open to a discussion about a Federal resolution of State review of investment company offerings. The remainder of the offerings are smaller and more localized. If there is any room at all for the concept of federalism in securities regulation, surely it encompasses these offerings which are not listed on national securities exchanges and are not part of the national market system.

It is also said by some that the costs of State law compliance are excessive. I would make three observations in response: One, while the aggregate costs of anything may sound large in a market as enormous as that of the United States, the actual costs of State and Federal compliance are a tiny percentage of any deal.

Two, while any costs are regrettable and we should all work to ensure there are no unnecessary costs, let us keep in mind that what issuers of securities buy with the dollars they spend on regulatory expenses is an environment in which investors have enough confidence in the integrity of the capital markets to invest in securities offerings.

And, three, in general the really significant expenses in the regulatory process are those related to Federal compliance.

Previous witnesses today have suggested that rather than prior review of offerings, States should limit themselves to after-the-fact enforcement of the antifraud provisions. I would suggest that this is too little, too late.

My written statement also addresses State licensing of brokers, an area where the States exercise their traditional police powers to protect their citizens. The States have made the procedure for obtaining a license very uniform and highly automated.

In the matter of enforcement, the States function as the cop on the beat, reviewing most of the investor inquiries and complaints and, in contrast to the SEC, dealing with matters which do not necessarily involve losses of millions of dollars. When elderly investors have been cheated out of their life savings, they do not understand that their case is too small to warrant government attention.

The States will continue to work with you and the SEC to clarify any ambiguities about what we do and to assure that there is an optimum division of labor.

Thank you very much.

[The prepared statement of Dee R. Harris follows:]

PREPARED STATEMENT OF DEE R. HARRIS, DIRECTOR, DIVISION OF SECURITIES, ARIZONA CORPORATION COMMISSION ON BEHALF OF NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Mr. Chairman and Members of the Subcommittee: My name is Dee Harris. I am Director of the Arizona Corporation Commission's Division of Securities and president of the North American Securities Administrators Association (NASAA), on whose behalf I appear here today. In the U.S., NASAA is the national voice of the 50 state securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level. I appreciate the opportunity to appear here today.

Mr. Chairman and Members of the Subcommittee, H.R. 2131, the "Capital Markets Deregulation and Liberalization Act," is broad in its scope and raises many issues with respect to the oversight of our capital markets. NASAA's comments today are confined to proposals contained in the bill's Section 3, "Creation of National Securities Markets." This Section includes amendments to the federal securities laws that would preempt most state requirements with respect to securities registration, broker-dealer licensing and regulation, and the regulation of investment companies and investment advisers.

I. INTRODUCTION

Mr. Chairman, I want to begin by acknowledging recent comments in which you have expressed a willingness to engage in an open, serious and informed dialogue with NASAA and others in an effort to identify and eliminate redundancies in the shared state-federal securities regulatory system *without* sacrificing market integrity and investor protection. I am here today to reaffirm that NASAA and its individual members are committed to ferreting out inefficiencies in the current system and to improving coordination between state and federal regulators. In an era of limited government resources, it is critical that we continually examine our regulatory programs to eliminate duplication and waste and to ensure that scarce resources are appropriately focused.

We do not believe it is inconsistent also to express NASAA's deep concern about, and opposition to, the sweeping federal preemption of state securities laws contained in H.R. 2131, the "Capital Markets Deregulation and Liberalization Act." It is NASAA's position that H.R. 2131 effectively would eliminate state securities regulation. As such, the bill would have a devastating impact on state investor protection efforts. State securities regulation is a crucial link in the U.S. investor protection "chain." Indeed, most one-on-one work with defrauded investors is carried out by the state securities agencies, not by the Securities and Exchange Commission (SEC), nor the industry self-regulatory organizations (SROs). The widely acclaimed enforcement capabilities of the states are predicated on the continued viability of state-level registration and licensing functions.

NASAA's opposition to key provisions of H.R. 2131, as introduced, however, should not be interpreted as an unwillingness on the part of the states to examine how we do business and to make reasonable changes. We believe that changes to the regulatory system are appropriate, and states recognize that good regulation requires a periodic critique of the law and practices. In fact, state securities administrators have led the way for decades in rethinking and streamlining the regulatory process. For example, the states were instrumental in the introduction of the Central Registration Depository (CRD) in 1981, thereby saving the securities industry tens of millions of dollars each year via one-stop licensing. In 1988-1989, the states moved to broaden the exemption from state-level scrutiny to include not only securities listed on the major exchanges, but all securities listed on the NASDAQ National Market System. The states also have moved to voluntarily establish a state-of-the-art, one-stop filing system for securities offerings that will operate alongside the SEC's EDGAR system.

Most recently, NASAA, building on ideas developed during a 1994 retreat, renewed its commitment to self-scrutiny and re-evaluation by convening a distinguished blue-ribbon panel of regulatory, industry and academic experts to look at how federal and state securities regulation may be modernized in order to eliminate regulatory burdens that do not contribute to investor protection. It is the charge of this group, known as the "Task Force on the Future of Shared State and Federal Securities Regulation," to craft carefully-considered solutions that do not sacrifice investor protection and do not cause an erosion of investor confidence in the greatest markets in the world. I am pleased to report that the Task Force held its first meeting last week and is off to a productive start. It is my intention to keep this Subcommittee and others in Congress fully apprised of the work of this group.

In addition, NASAA recently established several new committees to explore possible changes in state and federal securities regulation. One such committee will explore the feasibility of developing a multistate license for brokers with clean disciplinary records. Although enormous strides have been made over the past two decades in simplifying the licensing process for broker-dealers and their registered representatives, NASAA recognizes the expense, particularly for small firms, associated with keeping brokers licensed in a large number of states. A multistate license for brokers with clean disciplinary records might speed the licensing process and, if state legislatures agree, reduce fees by providing a discount for such a license.

Yet another NASAA committee will revisit the private placement exemption in an effort to achieve greater uniformity of procedural requirements among the states. We acknowledge that there is a lack of uniformity among state requirements in this area, caused in part by the changes sought by the various industry groups at the time that the state legislatures considered this issue. In addition, a committee has been created to study the Uniform Securities Act, which serves as the basis for the vast majority of the states' securities laws, and to develop appropriate amendments. Finally, as was reported to this Subcommittee last week, NASAA has entered into a Memorandum of Understanding (MOU) with the Securities and Exchange Commission (SEC), the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX), in which each signatory has agreed to share information regarding the scheduling of broker-dealer audits.

We all would be well advised to keep in mind the cautionary words of then-SEC Chairman Richard Breeden, who in discussing the Commission's staff study on investment companies,[1] warned:

> The world as you know it has changed a great deal since 1940 when the Investment Company Act was passed. In many respects, though, people have not changed since 1940. There is still a temptation when one has control over other people's money to use it in ways that one would not use one's own money. There is still a tendency for promoters to tell investors less than they need to know about performance, fees or related party transactions. There are still people who will simply steal from innocent investors. That is why the federal securities laws and in particular the Investment Company Act of 1940 are still necessary. The protections offered by the Act have helped to control abuse and in so doing foster confidence.[2]

Although Mr. Breeden's remarks were limited to the protections of the Investment Company Act of 1940, the same cautionary approach appropriately may be applied to this more general discussion. These remarks provide perspective on why it is that the concept embodied in laws that may be decades old are not necessarily outdated. Chairman Breeden's observation bears repeating today: Although the times may change, basic human behavior does not. As a result, we must be vigilant in ensuring that our regulatory system serves not only to take action after a fraud has been committed, but acts also as a deterrence against misconduct.

It is NASAA's view that fashioning a legislative initiative that addresses the twin concerns of fostering capital formation and maintaining market integrity will best be accomplished through an inclusive process that is open to all viewpoints and conducted in a deliberate and studied manner. Our capital markets are extraordinarily vibrant today and do not exhibit any of the characteristics one might assume would dictate a hurried, rush-to-judgment approach. We should take advantage of this relatively positive capital-raising climate to devise prudent measures, carefully-crafted and fully considered, that will help reduce the cost of oversight without jeopardizing market integrity.

Chairman Fields, you are to be commended for beginning this "dialogue," as you have characterized it, and for challenging all of us in the regulatory community to be smarter about how it is that we carry out our investor protection mandate. NASAA looks forward to working with you, other Members of the Subcommittee, and your staffs, as you move forward in your consideration of the legitimate questions regarding some aspects of the current regulatory system raised by H.R. 2131. We are confident that by working together we will identify those areas of regulation that are ripe for reform and design sensible and prudent solutions to address them. At the same time, we should identify those issues that are more complex and, as a result, will require additional examination before identifying solutions. Finally, we agree that there are issues that do not lend themselves to a federal legislative solu-

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[1] *Protecting Investors: A Half Century of Investment Company Registration*, Division of Investment Management, United States Securities and Exchange Commission, May 1992.

[2] Remarks of SEC Chairman Richard Breeden before the Investment Company Institute, May 21, 1992 (Executive News Service transcripts).

tion. In these instances, NASAA pledges to work with this Subcommittee, our co-regulators, and others to implement appropriate regulatory changes.

The balance of this statement is devoted to an exposition of the important state role in our system of securities regulation. In explaining what it is that the states do—and, equally important, what it is that the states do *not* do—this statement also will demonstrate that the sweeping preemptive provisions of H.R. 2131 effectively will eliminate state securities regulation. Finally, we will highlight the prudent deregulatory initiatives of the last several years undertaken by the states, and describe in fuller detail the work of the Task Force.

II. U.S. SECURITIES REGULATION: AN OVERVIEW

The fundamental purpose of securities laws is to provide investor protection and thereby foster the investor confidence that will encourage the investments necessary for capital formation, economic growth and job creation. By any measure, our system of securities regulation has met this basic objective. Despite the diversity of viewpoints that have been advanced on the specifics of H.R. 2131, virtually every commentator has agreed on one point: That the U.S. capital markets are the fairest, most successful and most liquid the world has ever known.

Today, more than 80 million Americans—nearly one in three households—participate in the capital markets. Increasingly, it is middle-class Americans who are finding that they must rely on investments to build retirement nest eggs, finance the college education of children, and save for major purchases. Indeed, the nation rapidly is moving toward a system in which most people will finance their retirement with their own savings and investments, rather than depend on government programs. Given the increasing reliance of the vast majority of Americans on the investment marketplace, it is critical that they have confidence they will be treated honestly and fairly in their dealings as investors.

It is not just investors who benefit from honest and fair financial markets. So too do the entrepreneurs seeking capital to help start or expand their business ventures. According to the SEC, more than 12,000 public companies tap the capital markets for funds to support new industries, finance operations, create jobs, fund research and development, and support growth for the future. During 1994 alone, over $800 billion of securities were registered with the SEC for sale in U.S. markets, and much more was raised utilizing various exemptions from registration.[3]

A well designed securities regulatory system should impose no costs or burdens that are not adequately justified by enhanced investor protection. The product of investor protection is investor confidence. The product of investor confidence is relative ease of raising capital for appropriate ventures. State securities agencies work on the front lines of investor protection and capital formation and they do it locally. If the authority of state legislatures is to be dramatically reduced in this area, it would be appropriate to very substantially augment the resources of the SEC, including opening far more SEC field offices (currently most states do not have an SEC or NASD office; the SEC recently has been closing offices).

The State Role In the Shared System of Regulation

Overseeing the multi-trillion dollar investment marketplace in the United States is an enormous task that directly affects the well-being of millions of Americans and requires the close attention of the federal and state governments. While the Securities and Exchange Commission rightfully commits its resources to broad, market-wide regulatory activities, state securities agencies devote the bulk of their efforts to those regulatory and enforcement issues that most directly affect small investors and small business capital formation.

The origin of the current system of securities regulation reflects the notion of our Founding Fathers that states should serve as laboratories of positive change.[4] Because of their proximity to, and relatively close relationship with the people they serve, state lawmakers have the capacity to identify and address the needs of their constituents in a manner that is expeditious and tailored to the specifics of that particular locale. Because of its size and location, the federal government simply lacks

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[3] Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning H.R. 2131, the "Capital Markets Deregulation and Liberalization Act of 1995," before the Subcommittee on Telecommunications and Finance, U.S. House of Representatives, November 30, 1995, p. 1.

[4] The uniquely American preoccupation with fashioning a delicate balance between national and state powers flows from the political philosophies espoused over two hundred years ago by our nation's founders. Indeed, the Tenth Amendment to the U.S. Constitution provides that "the powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

the capacity to respond promptly to the needs of certain segments of its disperse constituency. However, since creative initiatives by one state can, and often do form the basis for similar, but perhaps more refined legislation by other states and by the federal government, the entire nation benefits when states are afforded the opportunity to design legislative responses to local issues.

States exercised their roles as agents of change when, early in the twentieth century, they began to adopt statutes regulating certain securities transactions. In the unregulated markets of the time, securities fraud and speculation were major social problems. After they lost their savings, victims of these securities frauds agitated for government oversight. It was against this backdrop that in 1911 Kansas adopted the first state "blue sky" law[5] as a means of thwarting the schemes of securities dealers who were variously described as "fly-by-night-operators," "robbers," "vultures," "fakirs," etc. Forty-six other states passed similar laws before any action was taken at the federal level to regulate securities transactions.[6]

Thus, the development of a shared system of securities regulation confirms the notion that federal regulation often is written not on a blank slate, but on one that already displays the handiwork of the states. That is, federal legislation sometimes finds its genesis in a Congressional desire to fill in the gaps in an already existing state regulatory framework—gaps created not because a state regulatory approach is flawed but because our system of government cannot permit one state to ensure the complete efficacy of its attempts to protect its local citizenry by governing matters that take place wholly outside the state.

There can be no question that the integrity of local capital markets is a matter of strong state interest. The unique concerns of a state about the sale of securities to its residents has always been thought to justify the states' regulation of transactions bearing a sufficient nexus with the state. Such regulation has been deemed an appropriate exercise of state sovereignty. Indeed, as the courts repeatedly have recognized, state securities laws "involve matters traditionally within the province of state law." On the other hand, state securities statutes, although comprehensive, do not and should not cover the entire range of the capital markets.

The state and federal securities laws specify a high degree of division of responsibilities between state and federal regulators. The SEC oversees the securities exchanges and trading on the exchanges, while regulation of broker-dealers using the exchanges is left to the states and the self-regulatory organizations. Federal law contains the primary regulation of the activities of public reporting companies and proxy solicitation of its shareholders. State law, on the other hand, generally limits regulation of issuers to the initial public offers of start-up companies. State law generally exempts from regulation matters subject to adequate federal oversight, such as exchange transactions, government sale of securities, the issuance of bank and utility securities and mutual fund investment policies.

State securities laws provide for the protection of small investors through a three-pronged program involving the registration of securities offerings; the licensing of broker-dealers and their agents; and a wide range of enforcement efforts, including criminal prosecution of wrongdoers. The substantive state registration and licensing requirements act as an effective and proven "trip wire" for the early exposing of the conduct of abusive and fraudulent investment promoters. A detailed discussion of the major state-level functions follows.

III. STATE REGISTRATION OF SECURITIES OFFERINGS

Mr. Chairman and Members of the Subcommittee, NASAA appreciates this opportunity to set the record straight about state-level registration of securities offerings. While most state statutes provide for the registration of securities to be "offered" or "sold" to the residents of that jurisdiction, several exemptions from these registration requirements have been put in place. Most notable among the state registration exemptions is that which is provided for "any security listed or approved for listing

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[5] The term "blue sky" apparently originated in connection with the securities frauds perpetrated in Kansas. It has been written that the term indicated the evil at which it was aimed: that is, the "speculative schemes" that had no more basis "than so many feet of 'blue sky.'" For more information on the origin of state securities laws, see Manning Gilbert Warren III, "Reflections on Dual Regulation of Securities: A Case Against Preemption," *Boston College Law Review*, Volume XXV, Number 3, May 1984, pp 495-538.

[6] These early laws were the subject of extended legal challenges. However, the U.S. Supreme Court in 1917 held that the state securities laws were legitimate exercises of the states' police powers to promote the general welfare and protect their citizens. The Court recognized the factual accuracy of the argument that legitimate businesses might encounter some expense and inconvenience in attempting to comply with the state laws. However. the Court was unimpressed with the argument, noting that it costs something to be governed.

upon notice of issuance" on the New York Stock Exchange, the American Stock Exchange, the National Market System of the National Securities Dealers Automated Quotation system, and in most states, certain regional exchanges.

This "exchange exemption" is a recognition that certain securities required to meet the qualitative and quantitative standards of the exchanges do not require the additional oversight of state securities regulation. The widespread adoption of exchange exemptions reflects a responsible effort on the part of state securities administrators to relieve such securities in the national marketplace from individual state registration requirements.

In more recent years, state securities administrators responded to Congressional and other calls for a national market system through the adoption of a statutory recognition of the NASDAQ/NMS as the functional equivalent of a qualified stock exchange for the purposes of the registration exemption. As a result, the vast majority of the securities offerings registered with the SEC *automatically* are accepted by state securities administrators by virtue of the exemptions from registration for issues listed on the exchanges or the NASDAQ/NMS. The anecdotal evidence most commonly presented by opponents of state regulation all too often consists of examples many years old. Stale data and anecdotes from a bygone era simply cannot make an effective case against the work of the states, which has evolved dramatically in recent years. (In any case, the anecdotes, when examined in context often sound quite different.)

The Focus of State Registration Efforts

Today, the primary focus of state securities registration requirements is on those risky and illiquid investments, such as limited partnerships and penny stocks, where there is a greater challenge to ensure an "efficient" market and, as a result, abuses against small investors are most likely to occur. Among the serious problems that arise in thinly- or non-traded instruments are: a dearth of publicly-available information; and undue influence by the promoters and other insiders. These registration issues are of critical importance to small investors, and with the exception of investment companies, are not dealt with on a substantive basis under federal securities laws.

In addition, the states focus much of their registration activity on small company registration. Here we are talking about offerings that generally are less than $15 million and involve start-up companies. As detailed below, the states not only do not impede these offerings, they in fact serve as conduits for small business capital formation. By devoting thousands of staff hours per year in hands-on assistance to local entrepreneurs, state securities agency personnel serve as an important resource to their business communities.

State registration laws, like federal law, require full disclosure to investors of all material information. A large number of states, however, go further and provide for pre-sale review of securities offerings to inhibit promotion of blatantly fraudulent issues. Commonly referred to as "merit regulation," states applying substantive review to securities offerings generally apply standards with respect to: (1) underwriting commissions; (2) offering expenses and cheap stock; (3) the issuer's ability to make debt and interest payments; (4) the inclusion of unequal voting rights; and (5) the presence of excessive options and warrants. Because the states already have exempted from their review offerings listed on the exchanges or the NASDAQ/NMS, these registration requirements do not constitute a burden on national commerce.

In one of the most important steps taken by the states in recent years, NASAA expended several million dollars to develop and build the "Securities Registration Depository." Developed in coordination with the industry, the SRD will facilitate the state registration process by providing for true one-stop electronic filing of offering documents. The SRD will be linked to the SEC's EDGAR system and will permit true one-stop filing of securities offerings with the SEC and all of the states in which the offering must be registered. Documents filed with the SEC's EDGAR system automatically will be routed to the states via the SRD system. Once fully operational, the SRD system reduce paperwork and expense, while increasing certainty and easing compliance. NASAA looks forward to receiving the SEC's signature on a proposed Memorandum of Understanding for the link between the EDGAR and SRD systems. This hook-up between the systems will signal the achievement of the Congressional aim of accomplishing electronic, one-stop filing for issuers of securities. The MOU currently is under review by Chairman Levitt's office.

The Practical Effect of State Registration Requirements: The Pennsylvania Experience

In responding to a request made by this Subcommittee, the Pennsylvania Securities Commission conducted a review of the corporate equity offerings required to

register with the agency.[7] A copy of the Commission's December 1, 1995, preliminary report has been submitted to this Subcommittee. I would like to take a moment to highlight the key findings of the report, which will be instructive in this Subcommittee's deliberations:

- **The State-level review involved only a tiny fraction of all offerings.** Of the 2,639 registration statements for corporate equity securities filed with the Securities and Exchange Commission during the period of the study (July 1, 1994-June 20, 1995), *only 133 (or 5 percent) of all SEC filings also were subject to review by the Pennsylvania Securities Commission.*
- **No offerings underwritten by a national brokerage or investment banking firm were subject to substantive review by state agency.** All offerings filed by such firms during the period of this study withdrew the offerings to rely upon the self-executing exemption for securities listed or approved for listing upon notice of issuance on a major exchange, a regional exchange or the NASDAQ/NMS.
- **Over 75 percent of the offerings subject to state review were SB-2 and Regulation A offerings filed with the SEC.** These filings represent primarily initial public offerings by start-up or development stage companies which generally pose the most significant risks to public investors. A number of the offerings had underwriters who stated in the prospectus that they either had no previous experience as an underwriter or had very little such experience.
- **Offerings subject to state substantive review had serious regulatory concerns.** Exactly one-third of these offerings contained a qualified opinion of independent accountants expressing doubt as to the issuer's ability to continue as a "going concern." In over 25 percent of these offerings, the company asking the public to purchase its shares had loaned money to the company's principals which had not been repaid at the time of the offering. In approximately 49 percent of these offerings, the company, as of its last fiscal year, lost money. At least 16 of the companies had experienced losses since inception and 13 companies had received zero revenues from operations since inception.
- **A substantial majority of the offerings subject to state-level review raised the issue of escrow of promotional shares.** Two-thirds of the offerings contained substantial variances between the public offering price, the price paid by the promoters, and the pre-offering value of the company. By reasonably restricting for a finite period (usually one-three years, depending on the offering and discussions with company officials) the ability of the promoters to sell their cheap shares or to sell them at a price not below the public offering price prevents a depression in the market value of the public investors' shares and guards against promoters making a "quick profit" at the expense of the public.
- **State-level review does not impede international offerings.** Only *three* of the 133 offerings reviewed by the state were by foreign issuers. Two were registered with the state and the third offering currently is under review.

The results of the Pennsylvania study demonstrate that the state registration process does not unduly burden national or international securities offerings. To the contrary, the states focus their attention on the smaller, start-up companies that require greater scrutiny, and indeed, greater assistance on the part of state agencies.

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[7] Prior to 1972, Pennsylvania securities laws did not require the registration of securities offerings. Then, in the 1960s, a larger number of Pennsylvania residents fell victim to investment scams operated by promoters who raised money solely to pay themselves huge salaries. Responding to thousands of investor complaints and the loss of millions of investor dollars—as well as to the potential damage to its commercial reputation—the Pennsylvania General Assembly adopted legislation in 1972, requiring for the first time registration of securities offerings. The Act also contained a number of exemptions from registration for securities and securities transactions for which registration was not deemed necessary or appropriate for the protection of investors.

Under Section 205 of the Pennsylvania Securities Act of 1972, any security for which a registration statement has been filed with the SEC under the Securities Act of 1933 or any proposed sale pursuant to Regulation A promulgated under section 3(b) of the 1933 Act may be registered by coordination in Pennsylvania. Filing with the Pennsylvania Securities Commission (PSC) is made by using SEC documents, paying a fee and submitting a uniform application form prior to SEC effectiveness.

Section 208 (a)(v) of the 1972 Act states that the PSC may issue an order denying effectiveness to, or suspending or revoking the effectiveness of any registration statement if it finds that the order is in the public interest and the offering has been or would be made with "unreasonable amounts of underwriters' and sellers' discounts, commission or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options or has worked or tended to work a fraud upon purchasers or would so operate..."

The States and Small Business Capital Formation

In the wake of the adoption by Congress of the Small Business Investment Incentive Act of 1980, the Securities and Exchange Commission deferred to the states in the oversight of many offerings of $1 million or less. State securities agencies responded with a variety of rules and exemptions to assist small businesses in their capital formation efforts. From this round of innovative efforts emerged an experiment in Washington state, where officials of the Securities Division worked with members of the local securities bar to craft a simplified program allowing small businesses to make a public stock offering.

The goal in Washington state was to develop a streamlined disclosure document that an entrepreneur armed with a basic business plan could complete with only limited professional assistance and other costs. (The form also was to be intelligible to attorneys and accountants who are *not* securities specialists.) The State settled upon a simplified question-and-answer document. Once registered, the completed form doubles as an offering prospectus. This simplified disclosure process: (1) greatly reduces the expenses associated with registering an offering; (2) sets out the basic information needed to comply with state and federal securities laws; and (3) anticipates the questions most often posed by individual investors, venture capitalists and investment bankers.

The innovative Washington state program[8] went national in April 1989 as the Small Corporate Offering Registration (SCOR), which was adopted at that time as a model for use by the membership of NASAA. As of 1994, a total of 41 states had adopted the SCOR program. SCOR has been hailed by small business operators and others as a major breakthrough for legitimate small businesses seeking access to the capital markets. The following are the key features and requirements of SCOR:

- **Attention to small business needs.** The "plain English" question-and-answer format of SCOR greatly reduces the expense associated with preparing and filing a small business securities offering.
- **Up to $1 million may be raised.** The aggregate offering price of the securities in a SCOR offering may reach $1 million in a 12-month period.
- **Public solicitation and unrestricted securities allowed.** A SCOR registration frees an issuer of the necessity of following the tight rules governing other offerings, such as private placements.
- **Interstate offerings facilitated.** Under an exemption provided under federal Rule 504, a SCOR offering registered with a state need only provide the SEC notice by the filing of Form D. The combination of SCOR and the coordinated Rule 504 provision addresses the needs of a small corporation that has potential investors residing within the borders of more than one state.
- **"Blind pools" and penny stocks barred.** One of the ways that state securities agencies have tried to apply the lessons of the 1980s is by narrowing somewhat the scope of permissible SCOR offerings. "Blind pool" offerings—or any other in which the issuer cannot describe the specific business engaged in or property to be acquired—are not permitted under SCOR.

Many state securities agencies have embarked on an aggressive "get-out-the-word" campaign to educate would-be entrepreneurs about the capital raising process. State securities agencies have organized and conducted hundreds of seminars and workshops for small businesspersons seeking capital to start or expand a business. Yet other states have established small business assistance centers right in their securities agency. Local small businesspersons can visit these resource centers and get the kind of customized attention that would cost them thousands of dollars if it was being provided by securities counsel.

More recently, eight western states established a pilot program for the regional review of SCOR and other small business offerings. The six New England states are expected to follow the lead of their western colleagues and establish a similar regional review process. Under this format, one state agency takes the lead in reviewing the offering documents and in communicating comments and concerns to the issuer. As a result, the review process is greatly consolidated and simplified for the issuer.

Regional review is used at the option of the issuer. It is my understanding that the western states regional review process has now successfully been used in three offerings. In one case, a Washington state-based micro brewery sought to raise equity capital for the purpose of increasing brewing capacity, expanding distribution into a larger market area, and to purchase their facility. Washington state and Oregon agreed to a combined review of the SCOR offering. Importantly, as a result

[8] The state's innovative program was a 1990 recipient of the prestigious Arthur D. Little Excellence in Economic Development Award.

of the SCOR program and the joint Oregon-Washington review, *the company was able to conduct its securities offering without engaging securities counsel.* Thus, it was spared considerable expense in raising capital. The company's president expressed his satisfaction by telling the Washington Securities Division that it was the "most put-together professional and helpful government agency that they have worked with on both the state and federal level."

In other developments related to small business financing, the SEC now allows Regulation A offerings to be filed using the simplified fill-in-the-blanks offering document developed by the states. The states also have developed an issuers' manual (available via computer diskette or on paper) to guide small businesspersons through the process.

NASAA has collected examples from around the country of small businesses that have tapped the capital markets as a result of the state-level SCOR program. Given the level of direct assistance provided by state securities agency personnel in seeing these offerings through from start to finish, we justifiably are proud of our record here.

The Impact of H.R. 2131 on State Registration

Section 3 (a) of H.R. 2131 would preempt state regulation of most securities offerings that are registered with the Securities and Exchange Commission or qualify for exemption from federal registration. States would retain current authority with respect to purely intrastate offerings (although this is somewhat illusory because the existing intrastate exemption from federal registration contains some glitches that make it difficult to use)[9] and blank check offerings. In addition, states would retain the authority to require notice filings, consent to service of process, and fees. States also would retain the ability to enforce state antifraud laws, so long as the conduct involved also would violate the antifraud elements of section 17(a) of the federal Securities Act of 1933.

NASAA Position

As expressed earlier, NASAA is opposed to the preemption of the state authority to register and review securities offerings. Already, the states have recognized that offerings listed on an exchange or the NASDAQ/NMS need not submit to state-level oversight. NASAA, believes, however, that it would be detrimental to investors and to the marketplace for the states to be preempted from involvement in the registration and review of offerings that do not list on the exchanges or the NASDAQ/NMS. The SEC does not have the resources to review every filing it receives and as a result, may perform only a limited review or no review at all on a particular filing. If the states are removed from the field entirely, some offering documents may not be reviewed by at all. Additionally, it is difficult to quantify the effect of state registration on the quality of SEC filings. Efforts of issuers to meet the standards imposed by state regulation result in a higher quality offering being filed with the SEC than would otherwise have been the case.

Equally important is the fact that local small businesspersons will lose a valuable resource if the states are prohibited from registering securities offerings. Although a few offerings may continue to be submitted for state review under the intra-state provision, many small businesses would be forced instead to deal with a remote regulatory agency housed thousands of miles away in Washington, DC with little appreciation for local sensitivities or concerns. It is highly improbable that the SEC will be in a position to replicate the hands-on assistance provided to small businesses by a majority of state securities agencies.

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[9] See U.S.C. Section 77c(a)(11) (exempts "[a]ny security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory). The SEC promulgated Rule 1147 as a "safe harbor rule" to clarify the scope of the exemption. See 17 CFR Section 230.147.

The conditions imposed by Rule 147 has made it unworkable. To utilize the safe harbor of Rule 147, an issuer must have its principle place of business in a state, and be incorporated in the state in which it is proposing to issue the securities. Rule 147 imposes several conditions upon issuers, one of which requires that 80% of the proceeds of the offering be used in the states. 17 CFR Section 230.147 (c)(2)(iii). The SEC has actually taken action against a Minnesota corporation that had its only office in Minnesota and conducted an offering only to Minnesota residents because the proceeds would be used out of that state. SEC v. McDonald Investment Co., 343 F.Supp. 343 (D. Minn. 1972). The ABA has criticized Rule 147's unworkable nature, and argued that "it may be appropriate to change or eliminate the use of the proceeds test to permit issuers to apply proceeds out-of-state," Letter from Marc Moregnestern and Carl Schneider, Co-Chairs, ABA Section of Business Law to Linda Quinn, Director of the Division of Corporation Finance, SEC, August 9, 1995, page 6.

NASAA agrees with the position of SEC Chairman Levitt, who testified last week that there is a continuing need for the states to be actively involved in overseeing certain categories of offerings, including those that have been a source of frequent disclosure and sales practice abuses, such as penny stocks, blank check and blind pools, and limited partnership offerings. Direct participation programs, because of their complex nature, lack of liquidity for investors, and opportunity for self-dealing by the sponsors are well-suited to the types of review that have developed under state registration guidelines.[10] To that list, NASAA would add those small business offerings of $15 million or less.

In fact, to the extent that Congress is concerned about duplicative state-federal regulation of offerings, NASAA would suggest that the SEC abandon its oversight of smaller issues. The states are well suited to handle these offerings and should be allowed to assume primary responsibility in this area. To that end, Barry Guthary, Director the Massachusetts Division of Securities and then-chair of the NASAA Small Business Capital Formation Committee, more than 18 months ago wrote to then-SEC Commissioner Carter Beese suggesting that the SEC defer to the states on smaller offerings. Chairman Levitt appeared to endorse exploration of this concept in his testimony before this Subcommittee, in which he agreed that there is room for the Commission "to modernize the exemption from federal registration for intrastate and certain other offerings."

At the same time, NASAA recognizes that it must work to simplify the state-level process for private placements. I have publicly stated that I believe it is time for the states to revisit the private placement exemption. In general, the states have private placement exemptions which can be coordinated with the SEC's Regulation D. However, there is a great deal of procedural variance from state to state. This makes multistate private placements unduly complicated and serves no investor protection purpose. I have appointed a special committee charged with identifying ways in which to achieve greater uniformity of procedural requirements. We would be happy to report to the Chairman on the progress of the Committee.

IV. STATE REGULATION OF INVESTMENT COMPANIES

The last decade witnessed a dramatic flow of small investor dollars into mutual funds. Today, small investors who participate in the capital markets are most likely to do so through mutual funds. The mutual fund industry is justly proud of its accomplishments and relatively unblemished record. Investors have benefited by gaining lower risk and higher average return through the professional management and diversification inherent in mutual fund investing. At the same time, federal and state investor protection efforts in relation to mutual funds must be guided by the fact that many investors in such funds generally are of relatively modest financial means and financially unsophisticated.

While states continue to require the registration of investment companies, much of the state regulatory focus has shifted to the practices associated with the sale of mutual funds to investors. For example, it was the states that uncovered the abusive practices of First Investors, a case in which nearly 400,000 investors, many of them elderly, of lower income and financially unsophisticated, lost an estimated $585 million when the company misled them about the risks involved in two junk bond mutual funds.

Likewise, the states have taken a leading role in forcing changes in the way in which uninsured mutual funds are sold on bank premises. NASAA joined with the American Association of Retired Persons and the Consumer Federation of America to caution consumers that mutual funds sold on bank premises are not insured against loss by the government. Individual state securities regulators have worked with banks and securities salespersons in their states to improve the disclosure associated with such sales and to help educate consumers about he risk involved in uninsured investment products.

The Impact of H.R. 2131 on State Regulation

Section 3(c) of H.R. 2131 would add language to the Investment Company Act of 1940 to establish the Commission as having "the exclusive jurisdiction with respect to all securities and transactions" to which the Act applies, and to all persons to whom the Act applies. In order words, the states are preempted entirely from the field of investment company regulation. As a result, the states would not be able to enforce their antifraud laws in an effort to police against sales practice abuses. Instead, the federal SEC would be responsible for the entire job of overseeing investment companies.

[10] Statement of Arthur Levitt, November 30, 1995, p. 7.

NASAA Position

Although NASAA appreciates the concern of the investment company community about shared state-federal regulation, the Association is opposed to the broad preemption of the state role contained in Section 3(c) of H.R. 2131. Instead, NASAA would suggest that it be afforded an opportunity to work with the Investment Company Institute, the SEC and others in an effort to streamline state-level requirements with respect to the registration of investment companies.

V. STATE LICENSING OF FINANCIAL PROFESSIONALS

The threat to small investors does not begin and end with fraudulent schemes, since even legitimate investment programs made available by reputable securities firms can be subverted through misconduct on the part of habitual violators of state and federal securities laws and rules.

This concern becomes even more pronounced in view of the fact that growing numbers of middle-class Americans are now looking to market professionals to help steer them in their financial dealings. In these days of relatively lower interest rates, more and more savers have taken their money out of bank accounts or certificates of deposit and invested it in the stock market in the hopes of earning better returns. In addition, many more workers now are faced with making decisions about how to invest defined-contribution and self-directed pension plans.

These individuals, many of whom have had little or no prior investment experience, are entering the markets at a time in which we are experiencing "financial instrument overload," where even the most sophisticated among us have been thrust into a new and complex world of products for which we have no background to make the proper judgments. There is so much choice in the financial world today that many consumers find themselves utterly confused about where to put their savings and, as a result, often turn to others to make those decisions for them.

It is in this context that we consider the issue of the proper role of the states in overseeing broker-dealers and their registered representatives. As Chairman Levitt testified, state regulators have a compelling interest in determining who may do business within their borders and in how such business is conducted. Additionally, Chairman Levitt testified that the Commission believes that states should continue to license broker-dealers that do business within their respective jurisdictions. It should be emphasized that the vast majority of stockbrokers are honest, hard-working and well-trained professionals who take seriously their responsibilities. However, the damage inflicted by those who are prepared to defraud the market and investors can be tremendous and takes its toll not only on the individuals who are victimized, but on public confidence in the markets more generally.

One lesson to emerge from some of the more celebrated enforcement actions of the last few years is that, while the temptation sometimes is to assume that securities regulation and enforcement should be devoted entirely to fighting out-and-out con artists, an equally pressing problem deserving of regulatory and enforcement resources may be found in the area of fraud and abuse inflicted by brokers who operate out of some of the most prestigious brokerage firms in the country.

The CRD System

Today, the licensing of broker-dealers and their registered representatives is accomplished through the Central Registration Depository (CRD), a computerized system jointly operated by NASAA and the NASD. The system now contains registration and disciplinary files on more than 5,000 brokerage firms and over 450,000 individual stockbrokers.

Taking advantage of emerging computer technology, the CRD was established in 1981 in an effort to streamline and make more efficient the process by which state securities agencies license individual stockbrokers and brokerage firms. Previously, the states employed a disparate paper-based licensing system that required stockbrokers to fill out applications and take a "pencil and paper" exam in each of the states in which they intended to do business. With the advent of the CRD system, a stockbroker now fills out one application, takes one computerized exam and writes one check to cover the total fees. The completed applications, the results of the licensing exam, and the state registration fee are sent electronically via the CRD system to each of the states in which the applicant is seeking registration. This has greatly reduced the costs associated with state licensing and has greatly simplified procedures for industry compliance and state administration of the licensing process.

The rules of the states and the self-regulatory organizations require that broker-dealers and their registered representatives disclose certain relevant information during the initial licensing and registration process. Applicants must disclose infor-

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mation relating to criminal convictions, civil litigation, and administrative proceedings, if relevant, as well as prior employment history. After being granted a license to do business, the broker-dealer and their registered representatives are required to report if they have been the subject of regulatory or disciplinary actions, customer complaints or other specifically-identified activities or occurrences. The information is reported on Form U-4, the Uniform Application for Securities Industry Registration, which is accepted by the SEC, the states and the SROs.

State-Level Efforts to Weed Out Problem Brokers

Today, a growing number of state securities agencies are carefully scrutinizing the track record of individuals seeking licenses to do business in their states. For example, the State of Florida has credited its licensing program with playing a critical role in its success in cleaning up the penny stock fraud that riddled the state in the 1980s. Using its enhanced authority granted by the state legislature in the mid-1980s, the Securities Division of the Florida Office of the Comptroller has denied licenses to hundreds of applicants who had been approved for business by the NASD. The Florida Securities Division carefully scrutinizes the background of applicants for evidence of: (1) violations of antifraud provisions in the handling of customer accounts; (2) previous administration action by other state agencies; (3) violation of supervisory procedure provision; (4) prior or pending SRO actions; (5) criminal record; (6) SEC action; and (7) engaging in prohibited business practices.

Each year, state securities administrators screen out hundreds to thousands of stockbrokers who have been permitted to stay in the business by the NASD despite serious disciplinary records. One case from the State of Ohio will serve as an illustration of the broader state effort to weed out problem brokers. Consider the case of the stockbroker who remains licensed by the NASD but recently was denied a license to do business in the state of Ohio.

During 1993 alone, this individual was subject to customer settlements totaling over $400,000, as the result of customer complaints alleging conduct that ranged from fraud to misrepresentations and unsuitability. During the same year, this individual was held jointly and severally liable in an NASD arbitration in the amount of $150,000 based on allegations of misrepresentations in connection with the sale of securities. From 1990 to 1992, the stockbroker was a party to settlements totaling over $450,000 as the result of customer complaints in the sale of securities.

Many state securities agencies also monitor and track the activities of brokers who attempt to move from firms that have been identified as "problem" operations to other brokerages. In this approach, the states have attempted to put the brakes on the problem of "cloning," in which regulators shut down one problem brokerage firm only to find several new firms sprout up in its place, employing the original firms brokers. Because some problem brokers already are licensed before their first acts of misconduct become apparent, more and more states are imposing additional supervisory requirements in order to force firms and their branch offices to take direct responsibility early on for the activities of potential problem brokers.

By contrast, the NASD approaches the licensing of broker-dealers and their registered representatives from the perspective of full disclosure. So long as the broker-dealer or registered representative discloses all of the disciplinary history, meets the net capital requirements, and has passed the requisite examinations, the broker-dealer or registered representative generally will be granted a license. The only situations in which a broker-dealer or registered representative would be denied a license by the NASD or have its license revoked under the NASD rules would be for statutory disqualification cases and non-payment of a fine or arbitration award. Statutory disqualifications involve felony convictions, injunctions, fraud orders, and bars.

The Impact of H.R. 2131 on State Licensing Activities

Section 3(b) of H.R. 2131 would amend the Securities Exchange Act of 934 to, among things, preclude the states from applying registration, licensing or qualification requirements to any broker-dealer who is registered with the Securities and Exchange Commission or has been exempted from such registration, as well as associated persons.

In addition, the bill specifically prohibits the states from establishing broker-dealer capital, books and records, and reporting requirements that differ from those established by the Commission.

NASAA Position

States have a compelling interest in determining who may do business as a broker-dealer or registered representative within our borders, and in how such business is conducted. The states already have achieved uniformity of procedure in the licensing process through the CRD system, and the development of uniform forms

that are accepted by the SEC, the states and the SROs. Most recently, the states have moved, with others, to relieve firms of the unnecessary inconvenience of multiple audits and examinations by multiple regulators and self-regulators.

If Section 3(b) of H.R. 2131 were to become law, state securities agencies would have to rely entirely on what we believe are the less adequate standards employed by the NASD in screening out problem brokers. Having said that, NASAA recognizes that the strides made already by the states to streamline the licensing process and broker-dealer oversight may benefit from even further improvements. As mentioned earlier in this statement, a new NASAA committee now is looking into the issue of a multistate license for brokers.

An emerging troublespot for the states has involved the books and records retention of broker-dealers and the access of state securities personnel to the same. Although NASAA was prepared to tackle this problem though changes to state requirements, we are pleased to report that the SEC now recognizes this as a legitimate issue and has pledged to work with us to resolve our concerns on a national basis.

Mr. Chairman and Members of the Subcommittee, the issue of licensing of broker-dealers and their registered representatives is one which we do not believe lends itself to federal regulation. The states have a long and rich tradition of licensing the professionals who do business within their borders. Financial professionals are no exception. In addition, the states have demonstrated their ability to streamline and coordinate efforts with co-regulators. We do not believe there is any compelling case to be made for federalizing this function.

VI. STATE INVESTMENT ADVISER REGULATION

Whether you call them "investment advisers," "financial planners," or "financial consultants," millions of Americans each year seek the counsel of financial professionals. Today, 46 states[11] have laws on the books that govern the operations of investment advisers. While many of the "first generation" of state investment adviser laws are more comprehensive than what now is found at the federal level, NASAA members have recognized the need for a more complete investment adviser regulatory program. The NASAA model state investment adviser law and rules, adopted in 1987, are specifically crafted to compensate for gaps in the federal law and in the "first generation" state laws by incorporating the three essential elements of *prevention, detection* and *prosecution* into a "second generation" of state investment adviser statutes.

Most states define "investment adviser" in a manner similar to that of the federal Investment Advisors Act of 1940. In fact, NASAA and the SEC jointly developed Release 1092 concerning the applicability of investment adviser registration requirements to financial planners and other persons who provide investment advice as a component of other financial services. Because a large majority of investment advisers operate only at the state level and not at the national level, it was the states that first became aware of the real need to update and modernize the laws governing this burgeoning industry.

Consider the following key elements of the updated state investment adviser laws and regulations:

- **Registration of investment adviser representatives.** A majority of the states that currently oversee the activities of investment advisers also require that investment adviser *representatives* register with the securities agency. Under federal regulation, only *firms* are subject to the registration requirements; individuals are not. The registration of investment adviser representatives is a critical component of state oversight because it brings under the regulatory structure those individuals who deal directly with investors.
- **Screening applicants.** A significant preventive authority granted to most state securities agencies is the ability to consider the training, experience and knowledge of an investment adviser applicant and the authority to require an examination of such applicant as a condition of registration. Currently, states assert this prerogative by setting standards of experience, education and/or successful completion of certain examinations to assure some minimum measure of competence on the part of the persons holding themselves out to the public as experts in the investment advisory field.
- **Improved disclosure.** Many state laws and regulations require comprehensive written disclosure to clients regarding such issues as the qualification of the investment adviser, conflicts of interest, services offered and fees charged.

[11] The states of Colorado, Iowa, Ohio and Wyoming do not provide for the oversight of investment advisers.

- **Financial stability.** Many states have the authority to require some demonstration of financial stability by requiring an investment adviser to meet certain net capital, net worth or net tangible asset standards and/or produce a surety bond in a specified amount. In addition, some states impose such requirements if the adviser accepts custody, discretionary authority or prepaid fees from clients.
- **Broader antifraud provisions.** With respect to prosecution and deterrence, most state investment adviser laws include somewhat broader antifraud provisions than those found in the federal law. This is accomplished by the substitution of "any person" for any "investment adviser" in the language preceding the fraudulent practices provisions. The result is that the state antifraud provisions reach anyone receiving compensation for advice on the value, purchase or sale of a security, whether or not the individual is "in the business" or otherwise excluded from the definition of investment adviser.
- **Prohibitions on unfair and unethical business practices.** A number of states have adopted a detailed code of ethics for investment advisers, including suitability requirements.

Casting a wider net for the registration requirements and requiring a demonstrated knowledge of the laws through testing, state investment adviser laws and regulations include important preventive tools. The states use this authority to screen out abusive and fraudulent planners or advisers *before* investors are victimized. Additionally, consumers have a valuable information resource to consult before choosing a planner or adviser. Rather than finding out too late that a planner or adviser is operating outside of the regulatory structure, consumers may call state securities agencies for registration information.

The Impact of H.R. 2131 on State Investment Adviser Laws

Section 3(d) of H.R. 2131 would preempt state law entirely with respect to the regulation of investment advisers. The SEC would be granted exclusive jurisdiction with respect to all securities and transactions to which the Investment Advisers Act of 1940 applies and to all persons to whom the Advisers Act applies.

NASAA Position

SEC Chairman Levitt testified last week that there now are 22,000 investment advisers registered with the Commission and that this 500 percent growth in the last decade in the number of investment advisers has outstripped the ability of the Commission's examination and oversight resources. As a result, smaller investment advisers are now examined, according to Chairman Levitt, on average only once every 44 years. Most investment advisers would go their entire career without ever being examined by the SEC.

As a result, states have, in coordination and cooperation with the SEC, stepped up their own oversight and examinations of investment advisers. Indeed, the states are widely credited with having extremely effective investment adviser oversight programs and for closely coordinating their efforts with those of the SEC. For this reason, the states were shocked to find a total preemption of their authority in H.R. 2131. The preemption is so extensive that even state antifraud laws would not apply.

NASAA agrees with Chairman Levitt that the more appropriate course for Congress would be to adopt the "small adviser exemption" concept embodied in the legislation introduced earlier this year by Senator Phil Gramm. Under S. 148, the "Investment Advisers Integrity Act," the state securities agencies would assume primary responsibility for examining advisers who manage fewer assets. Larger advisers, in turn, would remain registered with the SEC and would be relieved from state registration and regulation.

It is this type of updated division of responsibility between the states and the federal government that NASAA commends to this Subcommittee as a framework for thinking about modernizing securities regulation in general. We are pleased to see that more recent comments of Chairman Fields indicate that he is reviewing the approach to investment adviser regulation suggested by his colleague, Senator Gramm.

VII. STATE ENFORCEMENT EFFORTS

Mr. Chairman and Members of the Subcommittee, there can be little dispute that the efforts of state securities agencies in fighting investment-related fraud and abuse are second to none. Indeed, the annual, aggregate number of enforcement actions carried out by the states far exceeds that of the SEC.

While we are proud of our enforcement record, we are dismayed that our enforcement function is so fundamentally misunderstood. Too often we have heard it said that the states should concentrate on what they do best: enforcement. Indeed, the

states have compiled an impressive record in bringing enforcement actions, including criminal prosecutions. But, most importantly, registration of offerings and licensing of broker dealers and their agents at the state level not only sets minimum standards for conduct, but also serves as the primary enforcement tool. In this sense, maintenance of state registration laws must be viewed as essential to state enforcement efforts. If the states are stripped of their registration and licensing functions, we will be rendered ineffective in our enforcement efforts.

Allow me to use one example to illustrate my point here. In 1991, the Massachusetts Securities Division learned of a boiler room operating in suburban Boston. At the time, American Microtel, a Nevada-based corporation was offering and selling the Microtel Wireless Cable Licensing TV Investment Program to the investing public throughout the United States. A review of the Division's records revealed that the Microtel Investment Program was not registered as a security with the Commonwealth. Acting expeditiously, the Securities Division sent in an investigator working undercover as a potential salesman. As a result of the undercover work, the Division confirmed that American Microtel was offering and selling unregistered securities. A Temporary Cease and Desist Order was issued on July 8, 1991. A short time later, NASAA funded a special project devoted to ferreting out fraud in the promotion of cable and wireless investment schemes. As a result of the NASAA special project, numerous enforcement actions were brought by state securities agencies against boiler rooms offering these "investments."

The point here is that Massachusetts was able to move quickly to shut down an obvious fraud. However, its ability to do so was predicated on its registration authority. In seeking the Temporary Cease and Desist Order, the Securities Division relied upon the fact that the security sold by American Microtel was not appropriately registered (or otherwise exempt) with the state securities agency. If the state instead had to rely on its antifraud authority, many more people would have lost their hard earned savings before the securities division could have taken action. Investigating and proving a full blown fraud case necessarily takes much longer to put together. While the case is being built, investors continue to be swindled.

In a March 1991 survey of state enforcement data, it was revealed that over 73 percent of all state enforcement cases filed involved allegations of violation of state registration or licensing provisions. As more and more state residents become aware of the need to contact their securities agency to determine whether an investment opportunity is registered, the states in turn will learn earlier of illicit activity taking place within their borders.

Wyoming Secretary of State Diana Ohman, who is responsible for overseeing securities regulation in the state, further illustrated this point in her September 29, 1995, correspondence to NASAA. In that letter, she wrote of the Northstar Investor's Trust/SLM Corp. scam that "may have gone undetected but for persons who called the Secretary of State seeking registration information knowing that securities and the people who sell them must be registered in states where investment solicitations occur." All told, the promoters took in $3.3 million from 23 investors before they were caught. If not for the registration and licensing authority of the state, many more people would have been caught up in the web.

Not only did the state learn of the scam when someone inquired about the registration status, but the state further relied on the lack of registration to secure the assistance of prosecutors in pursuing the case. Secretary Ohman reported that "Establishing lack of registration and use of false statements was pivotal in securing a commitment from the U.S. Attorney to investigate and prosecute SLM's scam. Lack of registration often establishes the threshold determination by a prosecutor that a provable violation of law has occurred and that a detailed investigation should ensure."

In short, conceding enforcement authority to the states while simultaneously taking their registration and licensing authority leaves state securities administrators with an empty plate. Enforcement, securities registration, and broker-dealer licensing are not mutually exclusive operations of state securities divisions. The three functions are interdependent. Simply stated, the bulk of state enforcement actions against fraud begin as a result of a promoter's failure to register the securities offering or to be properly licensed as a securities salesperson.

Finally, there are several types of investment frauds that are not addressed by federal law, but are covered under state securities laws. As a result, the states are the only agencies in a position to move effectively against these types of schemes. In some instances, the SEC attempted to bring enforcement actions but was rebuffed when federal courts said the conduct did not involve a "security," and as a result, the SEC lacked jurisdiction. Some examples here include oil and gas lease investments, cellular application lotteries, "dirt pile" schemes, and so-called "exotic" investment schemes.

The Impact of H.R. 2131 on State Enforcement Efforts

Proponents of H.R. 2131 argue that it will direct state resources where they are put to maximum use: enforcing the law. Precisely what law the states will be enforcing is somewhat less clear. It appears that the states would be left to enforce federal law. If that is the case, NASAA is not sure how the process would work. Most state securities statutes allow them to enforce their own securities laws, not those of another jurisdiction. Under H.R. 2131, state legislatures would have to decide if they wanted to fund the enforcement of federal laws.

Limiting the state role to enforcing federal standards is further complicated by a host of practical questions, including: Who interprets what the federal standards are? Will each of the 50 states and 50 state courts be allowed to interpret the federal laws? Or, will these cases have to be brought in federal court? If so, what standing do the states have to go into federal court?

NASAA Position

NASAA recommends that the state securities agencies be permitted to continue to enforce *state* securities laws, including those pertaining to registration of offerings and licensing of individuals. As has been amply demonstrated in this statement, NASAA and its individual members have already taken steps, and will continue to seek improvements in the current system to eliminate inefficiencies and unnecessary burdens on capital formation that do not serve an investor protection function.

VIII. PRUDENT REGULATORY REFORM

Mr. Chairman and Members of the Subcommittee, NASAA's opposition to the sweeping preemptive provisions of H.R. 2131 does not mean that the states oppose needed changes in state and federal regulatory requirements. On the contrary, states have been leaders for decades in this regard and will continue to work toward better coordination with co-regulators and further streamlining of the regulatory process.

This testimony already has highlighted many of the important innovations at the state level in the area of regulatory reform. Here I would like to provide additional detail on the Task Force on Shared State and Federal Securities Regulation. Learning more about the composition of and charges to the Task Force may help reinforce for you a sense of NASAA's commitment to self-scrutiny and examination.

We are pleased that so many distinguished thinkers in the field of securities regulation agreed to participate in this important undertaking. Members of the Task Force are: Securities and Exchange Commission Member **Steve Wallman,** Washington, DC. Former SEC Chairman **David Ruder**, who is currently William W. Gurley Professor of Law, Northwestern School of Law, Chicago. Merrill Lynch & Co. Vice Chairman **Steve Hammerman**, New York City. Paine Webber General Counsel **Theodore A. Levine**, New York City. Former Pennsylvania Governor and U.S. Attorney General **Dick Thornburgh**, partner, Kirkpatrick & Lockhart, Washington, DC. American Stock Exchange Chairman and Chief Executive Officer **Richard Syron**, New York City. Regional Investment Brokers Association (RIBA) Chairman **Tony Petrelli**, senior vice president, Neidiger/Tucker/Bruner, Inc., Denver, CO. Investment Counsel Association of America Executive Director **Mark Tomasko**, New York City. Former chairman of the State Regulation of Securities Committee of the American Bar Association **Hugh Makens**, partner, Warner, Norcross & Judd, Grand Rapids, MI. Author of *The Transformation of Wall Street* and co-author with Louis Loss of a 12-volume treatise on securities regulation **Joel Seligman**, dean of the College of Law, University of Arizona, Tucson. Former SEC Director of the Division of Investment Management **Marianne Smythe**, partner, Wilmer, Cutler & Pickering, Washington, DC. NASAA President and Director of the Securities Division of the Arizona Corporation Commission **Dee Harris**. Immediate past NASAA President and Colorado Securities Commissioner **Philip Feigin**. NASAA President-Elect and Utah Securities Division Director **Mark Griffin.**

The concept of the Task Force had its genesis at a members-only retreat sponsored by NASAA in Chantilly, VA, on September 16-17, 1994. At that session, state securities regulators openly debated what changes would make the most sense in the manner in which they regulate the investment marketplace. In some cases, members of the Association spoke in favor of shifting away from some regulatory activities and elevating the emphasis on others. Other proposals centered on a possible reallocation among state and federal securities regulators of their existing division of labor.

Other than setting the initial meeting, which took place in St. Michaels, MD last week, NASAA is not directing the work of the Task Force. However, NASAA is asking that the panel conclude its work speedily. Regular meetings of the Task Force

will be held during which representatives from industry trade groups and associations, law professors and the American Bar Association will be called upon to testify regarding the issue to be discussed.

Mr. Chairman and Members of the Subcommittee, NASAA initiated this important process of self-scrutiny and re-evaluation 15 months ago, before any proposal bearing on our work was taken up by Congress. Today, we believe it is more important than ever that we devote the time needed to hear all viewpoints relevant to the question of how the federal and state governments should regulate the investment marketplace. Whether it is the consensus that the states should do more or less as a result, NASAA is committed to ensuring that the Task Force goes about its work and deliberations as the Task Force sees fit. No topic or proposal is off limits, as long as it leaves in place the essential cornerstones of market integrity and investor protection. We envision a deliberate approach that will result in meaningful and constructive change.

IX. CONCLUSION

Mr. Chairman and Members of the Subcommittee, any regulator can tell you astounding stories of investment frauds that have devastated families' and individuals' dreams of college educations, comfortable retirement or the like. The stories of elderly victims that have lost their life savings are too numerous to recount. There is another factor to keep in mind as well. We need to ensure that we do not relax regulatory oversight of the markets to such an extent that we inadvertently divert capital from legitimate business development and the building of needed infrastructure. Comprehensive and fair regulation not only is good for investors, it is good for economic growth and development.

We often are reminded of the rapid pace of change in the U.S. and world capital markets. Indeed, changes are reshaping the markets. However, even in a global marketplace, state governments must be allowed to continue to perform their essential and unique job of protecting small, individual investors. No doubt things would be easier for large companies seeking to raise money in the capital markets if they never had to deal with any regulators. But today's state regulation appropriately focuses its attention elsewhere—on the small investor and point-of-sale abuses. State criminal prosecution, administrative sanctions and state registration requirements continue to constitute the bulwark where individual investors are most likely to have recourse to protect them from abuses and to right wrongs that have been done. Thank you.

Mr. FIELDS. Thank you, Mr. Harris.

Mr. Mark Saladino, representing the Government Finance Officers Association.

STATEMENT OF MARK J. SALADINO

Mr. SALADINO. Thank you, Mr. Chairman.

As you know, my name is Mark Saladino and I am an attorney for Los Angeles County, California. I am responsible for representing the county, as well as many other subordinate public agencies, in finance and investment matters.

I am here today on behalf of the Government Finance Officers Association. GFOA is a national financial organization, representing over 13,000 State and local government officials who are both elected and appointed and who are involved in all the various disciplines related to public finance.

We appreciate being given this opportunity to testify. And we very much appreciate the Chairman's willingness to consider a variety of opinions on this legislation.

My testimony here today will focus only on the suitability issues addressed in Section 2 of H.R. 2131, and I would like to make four basic points:

First, in our view, suitability rules are an important part of the securities dealer's professional responsibilities. Securities brokers and dealers are skilled, licensed professionals. The very nature of

the services they perform require a high degree of trust and confidence on the part of their clients, similar to the trust and confidence that characterizes the relationship between an individual and his or her doctor or lawyer.

Just as it would be unthinkable for a physician to prescribe treatment without first examining the patient, we submit that a securities dealer should not be allowed to affirmatively recommend investments without first considering the client's needs, goals and financial resources.

Second, I would like to respond directly to some assertions made by other witnesses before this committee to the effect that suitability rules are an attempt to make securities dealers guarantors of investment success. I think that history is the best evidence that this is simply not so.

In certain securities markets, suitability rules have been in effect for years. But I am not aware of a single reported case in which suitability rules were used to impose liability against a securities dealer.

Over the last 15 or so years, there have been several very well-publicized disputes involving investment losses, but to my knowledge, every such case which resulted in a judgment against the dealer was based on a finding of fraud or breach of fiduciary duty.

In my view, Section 2 of the bill really is a remedy in search of a problem. And although this may sound a bit cynical, I believe it is supported by some groups of dealers in an attempt to whittle away at other important investor protections, including antifraud statutes, which have made American markets the safest and most liquid in the world.

Third, this bill would shift to investors the entire responsibility for evaluating alternative investments. Just as it would be wrong to make dealers guarantee investment success, it is also wrong to absolve them from any responsibility to utilize their skills, training and experience and simply to know their customers.

Securities dealers and their clients both need to actively participate in transactions, and in our view, the goal of legislation and regulation should be to strike a proper balance between the rights and responsibilities of both parties.

In our view, Section 2 unfairly tips that balance in favor of the dealer almost without exception. At the very least, if a presumption in favor of broker/dealers is to be enacted into law, it should be rebuttable by evidence of the particular relationship of the parties. A court should not be precluded from considering oral representations as well as the parties' prior dealings with each other.

Fourth, we disagree with the notion that the size of an investment portfolio directly correlates with the sophistication of the investor. When speaking of government agencies, $10 million is not an enormous sum. It is not uncommon for even a very small rural school district to have $10 million at certain times of the year, and jurisdictions with billions of dollars under their control still rely on their securities dealers, quite properly, in our view, not to try to sell them inappropriate investments. So we don't believe that Congress should define by statute a sophisticated investor by reference to a $10 million threshold.

In fact, we don't think that any fixed dollar amount is a suitable proxy for evidence of sophistication. We respectfully suggest that an investor's level of sophistication should be permitted to be raised by a securities dealer as an affirmative defense to liability. But the investor's sophistication should be proven by evidence of his or her training, experience, and similar factors on a case-by-case basis.

In conclusion, I would like to echo a sentiment expressed to you by SEC Chairman Levitt. We would urge this committee to permit continuation of the regulatory effort which began under the bipartisan Government Securities Act amendments of 1993. As you know, the National Association of Securities Dealers has proposed a rule that addresses the concerns raised by PSA, SIA and other broker/dealer representatives.

We believe that the Congress should allow the SEC's rulemaking process to continue. After it is completed and regulations put into effect, we strongly suspect that the result will be valuable investor protections without placing an undue burden on securities dealers. That is the reality of existing suitability rules.

If things unexpectedly turn out differently, Congress can always revisit the issue and take appropriate action at that time.

That concludes my prepared testimony.

I thank you for your attention and I would attempt to answer any questions you may have.

[The prepared statement of Mark J. Saladino follows:]

PREPARED STATEMENT OF MARK J. SALADINO, PRINCIPAL DEPUTY COUNTY COUNSEL, LOS ANGELES COUNTY, CALIFORNIA

INTRODUCTION

My name is Mark J. Saladino. I am a Principal Deputy County Counsel for Los Angeles County, California, specializing in the areas of finance and investment. I also handle finance and investment matters for the Metropolitan Transit Authority, most school and community college districts within the County and numerous other subordinate local agencies, authorities and nonprofit corporations. I am here today on behalf of the Government Finance Officers Association (GFOA). GFOA is a national professional association representing 13,000 state and local government officials, both elected and appointed, and other public finance specialists whose responsibilities include all the disciplines related to public finance. We appreciate being given this opportunity to testify and further appreciate the chairman's willingness to solicit a variety of opinions on this legislation. My testimony will focus solely on suitability and the issues raised by Section 2 of H.R. 2131, the Capital Markets Deregulation and Liberalization Act of 1995, legislation designed to lower the cost of capital to American business, reduce compliance costs, and eliminate duplicative regulation.

THE NEED FOR INVESTOR PROTECTION

Why is investor protection, as typified by suitability rules, so crucial for state and local investors? State and local governments are significant buyers of securities and have an immediate and direct interest in seeing that the financial markets are safe, stable and liquid. In federal government securities alone, state and local governments held $480 billion of the total U.S. Treasury debt of over $4.9 trillion outstanding. This represents approximately 10 percent of the total and approximately 17 percent of the federal securities market that is not held by foreign investors or federal agencies as of the first quarter of 1995 (*Federal Reserve Bulletin*, Vol. 81, No. 10, October 1995, Table 1.41). As of fiscal year 1990, total state and local government cash and securities holdings were $1.5 trillion (Council of State Governments, *Book of the States 1994-95*). Periodically, due especially to the timing of tax receipts, even small governments have significant amounts of money. While not all of these

assets are available for investment purposes, it is clear that state and local governments entities are major market participants.

Because of their role in financial markets, state and local governments have an interest in assuring that brokers and dealers trading in securities are held to a high standard of care and adhere to rules of fair practice. It is important that governmental investors, entrusted with public funds, have confidence in a broker or dealer in order for them to make the most advantageous yet appropriate investments for their jurisdictions.

ADHERENCE TO STANDARDS OF PROFESSIONAL CONDUCT

All licensed professionals, from accountants to building contractors, are held to standards of professional responsibility commensurate with the skills they are required to possess and the nature of the services they perform. The requirement to adhere to rules of fair practice and ethical standards in any profession does not shift the burden of responsibility for successful performance to the practitioner. A lawyer who tries a case, for example, must adhere to ethical standards of conduct, but by his doing so is not considered by his clients to have guaranteed that he will win the case. In the area of securities, courts have traditionally recognized the so-called "shingle theory," which holds that by "hanging out his shingle," a broker-dealer undertakes to deal fairly with his customers. To ensure that this occurs, rules of fair practice, including suitability rules, have been adopted. Federal regulations also impose other duties on dealers in securities, as contrasted with issuers or purchasers.

For example, in the context of municipal securities, Securities and Exchange Commission (SEC) Rule 15c2-12 requires that an underwriter review a disclosure document before offering the securities for sale. Also, before recommending a municipal security for purchase, a broker-dealer must have procedures in place to assure that he will receive notice of designated material events affecting the issuers whose securities are traded. No one would suggest that these existing rules of professional conduct have transformed broker-dealers into guarantors of the accuracy or adequacy of disclosure. Likewise, suitability rules have never been construed to guarantee successful investing. Despite the repeated claims of the broker-dealer industry, GFOA has never advocated shifting the burden for losses incurred by a jurisdiction to the broker-dealer. Instead, we recognize that the duty of responsible investing is a shared duty that falls on both parties to a transaction.

"Best practices" dictate that finance officers have the continuing responsibility of balancing safety, liquidity and yield, in that order. In fact, that responsibility was recently codified by a statute enacted by the California legislature. In taking their fiduciary responsibilities seriously, finance officers attempt to maximize their jurisdictions' investment earnings by investing in what they understand to be "safe" obligations, but which they may not understand as thoroughly as a licensed securities professional. Governments properly rely on the information, advice and recommendations received from those who hold themselves out as experts, because often managing investments is not their principal—or even their most important—duty. Regardless of the size of their portfolio or their level of sophistication, state and local government investors are unlikely to have access to either the quantity or quality of information relating to specific investment instruments that a broker-dealer has. Broker-dealers have real-time, virtually unlimited access to information, such as pricing, structure, and risk factors of an instrument, information not readily available as a practical matter to most state and local government investors. As SEC Chairman Arthur Levitt stated in a recent speech to the International Swap Dealers' Association, "There's no question that the dealer is best suited for *clarifying* those obligations and responsibilities. Dealers must recognize their interest in doing so up front, before the deal is made." ("Derivatives Use in the 1990s," November 9, 1995.)

The concept of professional responsibility is as important to the securities market as personal responsibility is to society as a whole. Many thoughtful commentators, including numerous members of Congress, have correctly argued that society would benefit from a greater emphasis on personal responsibility, and that individuals should be held accountable for the consequences of their own behavior. Suitability requirements and other standards of professional conduct are intended only to extend this notion of accountability from a social context to a business context. Suitability rules do not make broker-dealers responsible for all of their clients' trades; rather, they impose a minimal burden on trained professionals who make affirmative recommendations. The repeal of suitability rules would unfairly tip the balance of rights and responsibilities in favor of broker-dealers, with potentially disastrous consequences for investors and society.

For example, imagine a world in which lawyers were permitted to give legal advice without regard to the particular facts of the client's case, or doctors were permitted to suggest medical treatment without regard to the patient's physical condition. Elimination of suitability requirements would have the same effect on the investing community. A broker-dealer could recommend any security to any client, without consideration of the client's particular needs or financial situation. The effects of such an environment on investors are obvious. Perhaps less clear, but equally important, are the potential negative effects on the integrity of the securities markets. Such effects include a loss of confidence in financial markets when potential investors perceive them as being somehow less stable or safe than they are now. This could discourage capital investment and increase the cost of capital, frustrating H.R. 2131's goal of encouraging less costly and more accessible capital.

INVESTMENT POLICIES AND PRACTICES

As a sign of our commitment to responsible investing, GFOA has long advised its members to exercise caution in the investment of public funds. It is GFOA policy that investors obtain competitive bids and proposals from securities dealers, or verify through other means that the prices being offered are reasonable, and that finance officers secure acknowledgment from their depositories and dealers of receipt of written copies of their investment policies, risk constraints, and trading requirements. Governmental investors are also advised to be aware of reasonably foreseeable risks of market price loss, illiquidity, nonmarketability, or default of investment instruments prior to purchase.

GFOA first approved model investment legislation for state and local governments in 1984 that provides a universe of appropriate investment instruments and outlines a series of considerations that should underlie the application of an investment policy at a state or local government level. That model legislation was updated in 1992 and is currently under review.

In 1995, GFOA approved a recommended practice supporting the use of written investment policies for state and local governments and at that time issued a sample investment policy that is intended to serve as a guide for the preparation of state and local government investment policies. An increasing number of jurisdictions are creating detailed written policies to direct their money managers. Written policies typically specify not only the types and maturities of instruments in which public funds may be invested but also the types of institutions and dealers with which business may be transacted, standards of care and reporting requirements. In my state of California, written investment policies will be required for nearly all investing jurisdictions by statute as of January 1, 1996.

As part of GFOA's continuing effort to bring more certainty to the relationship between institutional investors and broker-dealers, we developed a sample broker-dealer agreement, with input from the Public Securities Association (PSA), that provides guidelines for establishing a trading relationship between broker-dealers and governmental units. Such an agreement assists all parties to a transaction in understanding the information to be disclosed by broker-dealers and governmental investors and recognizes the participants' respective responsibilities for dealing with the suitability of investments. GFOA, as a matter of policy, has urged its members to enter into such agreements with their broker-dealers.

Clearly, GFOA does not expect or advocate that dealers become insurers against loss by customers that may result from market fluctuation or poor choices by the investor. However, not even the adoption of GFOA's investment guidelines, the use of an investment policy, nor an agreement with a broker-dealer can effectively protect a jurisdiction against a broker-dealer who does not make suitable recommendations consistent with his or her training, skills and professional responsibilities.

SUITABILITY

One of GFOA's particular concerns in all financial markets is the issue of suitability. Suitability obligations on the part of broker-dealers arise in discerning the relationship between a particular instrument and a customer's constraints and affinity for risk. For example, because of the risk associated with some obligations, even some government securities, a given instrument may not be appropriate for a specific investor. Because of the liquidity needs of governments to pay operational expenses, payrolls, etc., instruments that are inherently risky, that may become illiquid, or that are long-term and therefore more subject to market fluctuations, are inappropriate for short-term cash management purposes, although they may be appropriate instruments for pension funds that traditionally and properly invest in long-term instruments of many types. As the recent example of Orange County viv-

idly demonstrates, losses may occur if long-term securities must be sold in order to satisfy cash-flow needs.

Our members report that many new and complex instruments that have proven to be risky are being aggressively marketed to state and local governments, which are assured in some cases by the broker-dealer sales force that the products are safe, government-guaranteed, and will protect principal. If the value begins to decline, some finance officers have been assured that the instrument will bounce back. In short, some cautious finance officers believe that they have been misled by broker-dealers and that these products have been misrepresented, in part due to a lack of understanding by the broker-dealer trading them and in part because of the incentives to sell because of the large commissions dealers earn. There is a decided lack of information available to finance officers regarding specific instruments, even from outside investment advisers or bond counsel, who are often unfamiliar with these instruments.

The concept of suitability has applied to securities markets since the National Association of Securities Dealers, Inc. (NASD), registering under the Securities Exchange Act of 1934, adopted Rules of Fair Practice. The current discussion did not begin recently. While some have argued that suitability rules are unnecessary as long as anti-fraud statutes exist, we know that there are egregious practices that may fall short of fraud, or where, by their very nature, intent to defraud is difficult to prove. Such misconduct, even where it does not rise to the level of fraud, must be deterred. Suitability rules apply only to affirmative recommendations of trained securities professionals, and they are entirely consistent with other federal regulations that impose duties on securities dealers. While market participants may disagree about what constitutes a "recommendation," there should be no disagreement about the application of suitability rules when a recommendation is made.

Even where investments may be legal or approved, they may still be unsuitable. For example, a 30-year Treasury bond may be an unsuitable instrument if the funds used to purchase it will be needed in six months. And even where there is no net loss, investments may be unsuitable given the needs and policies, as well as the applicable laws, of that jurisdiction. A number of state and local governments, in addition to private sector entities, have experienced investment losses, not only recently, but in the past decade. Because of these losses, and the fact that many of them could be traced to reprehensible actions on the part of broker-dealers, Congress enacted the Government Securities Act of 1986 and the Government Securities Act Amendments of 1993. Federal law now authorizes sales practice rules governing suitability, price mark-ups and churning in all financial markets.

GOVERNMENT SECURITIES ACT AMENDMENTS OF 1993 AND THE NASD SUITABILITY INTERPRETATION

In 1993, Congress passed the Government Securities Act Amendments which authorized sales practice rulewriting for the government securities market by the NASD and financial institution regulators. This legislation came about largely as a result of this subcommittee's efforts, and particularly due to the support of the bipartisan leadership of this subcommittee. Beginning in the 1980s and continuing into the 1990s, scandals in the government securities markets threatened to shake public confidence in the fairness and integrity of those markets. Congress recognized that, among other sales practice abuses, broker-dealer recommendations of unsuitable investment instruments had become serious enough that it required a regulatory structure to curb it. GFOA strongly supported inclusion of sales practice rules in the Act.

As part of the rulemaking process under the 1993 Act, the SEC recently released for public comment the proposed NASD suitability interpretation. Comments were due November 14. The NASD rule establishes that the suitability obligation of a broker-dealer is potentially applicable to all institutional customers (with the rule being particularly applicable to those institutional investors with portfolios of $10 million or more) and that the determination of such an obligation rests on the broker-dealer. The rule uses two general guidelines in determining the scope of the suitability obligation to the customer: the customer's capability to evaluate investment risk independently and the extent to which the customer exercises independent judgment.

GFOA has submitted comments to the SEC on the proposed NASD suitability rule. While we are generally supportive of the NASD's position, we have recommended to the SEC, which is now considering whether to approve the rule, that the rule be amended to include an affirmative duty on the part of the broker-dealer to inquire about the investor's goals and objectives and to inform the investor of identifiable risk factors and other information regarding the features of specific in-

struments. In addition, GFOA opposed the $10 million portfolio size designation for the following reasons: (1) committee report language accompanying the 1993 Act specifically prohibits distinctions in the rules based on the size of a portfolio; (2) the inclusion of a dollar amount distinction contradicts the stated intent of universal applicability of the suitability rule; and (3) the $10 million designation is unclear and difficult to apply. In the context of a state and local government portfolio, $10 million is a minimal amount, so the vast majority of state and local governments would be affected by these guidelines.

Although we have recommended some changes to the rule, GFOA believes that the proposed NASD rule, once adopted by the SEC, will provide a balanced approach to the issue of suitability for both institutional investors and broker-dealers. We agree with SEC Chairman Arthur Levitt's testimony last week before this subcommittee, in which he stated that, "if adopted, the NASD's proposed approach may resolve many of the concerns raised by market participants concerning their suitability obligations. We therefore urge Congress to allow the rulemaking process to continue before enacting legislation in this area." (Testimony, November 30, 1995, pp. 22-23.) There is no evidence to show that there has been any particular change in broker-dealer circumstances indicating a crisis that necessitates Congress' revisiting its 1993 legislation at this time, particularly when the rulemaking process under that statute is not yet complete.

SECTION 2 OF H.R. 2131

Section 2 of H.R. 2131 would effectively repeal both the provisions of the 1993 Act regarding sales practice rules and the as-yet unadopted suitability rule itself. This section, together with other sections of H.R. 2131, could also be construed to supersede recent state suitability legislation. The new provision would accomplish this by establishing a legal presumption that a broker-dealer would not be liable for investment decisions of institutional investors unless a written agreement to the contrary exists. Even where such an agreement exists, the provision would put the burden on the investor to disclose a broad array of certain portfolio information to the broker-dealer. We are concerned that the difficulties and limitations associated with rebutting the presumption in favor of broker-dealers could impinge on customers due process rights. Also troubling about this provision is the definition, presumably derived from the proposed NASD rule, that an institutional client is any entity with at least $10 million in securities holdings.

First, as we indicated with regard to the NASD rule, the committee report language accompanying the Government Securities Act Amendments of 1993 shows that Congress intended all categories of investors to be covered equally under the statute. The relevant Committee on Energy and Commerce report language states

> Accordingly, the Committee intends that sales practice rules regulating the activities of brokers and dealers issued under this Act shall encompass all categories of investors, including governmental investors of public funds, as is the case with sales practice rules in other markets. *No distinction between investors on the basis of size of portfolio shall be made* (emphasis added). For example, the appropriate analysis of suitability will be based on the sophistication and goals of the investor balanced against the characteristics of the trading strategy or investment recommended by the dealer.

Second, the imposition of the $10 million threshold itself is inappropriate. Congressional prohibition of a portfolio-size standard was based on the recognition that an arbitrary threshold is not indicative of sophistication nor expertise, as recent events have demonstrated. Proposals such as those in H.R. 2131 are made based on the mistaken assumption that an entity whose budget or investment portfolio exceeds a given level is somehow deemed to be "sophisticated." We now know that size does not equal sophistication, and that whether or not there is a suitability issue depends not only on the level of expertise, knowledge and ability of the investor, but on the facts and circumstances of a given case—including the fact that, as custodians of public funds needed for public purposes, state and local governments normally have a much lower risk tolerance than their private sector counterparts.

Many large sources of municipal revenue, such as property taxes, are payable only once or twice per year. As a result, city and county finance officers are often responsible for the temporary investment of huge sums during certain times of the year, and many millions of dollars regularly throughout the year. This temporary investment of idle cash may be only a part of a finance officer's duties, which further increases the likelihood that the finance officer will not possess the investment expertise that the size of his or her portfolio would imply. As Chairman Levitt indicated last week, it is difficult to group all categories of institutional investors together and

to presume a uniform level of sophistication or resources among such a disparate group.

Third, GFOA believes that H.R. 2131's suitability provision directly contradicts the intent and the direction of the proposed NASD rule. While the NASD rule is "potentially applicable to *any* institutional customer," H.R. 2131 severely limits the applicability of any meaningful suitability obligation to only the very smallest of institutional investors, those with portfolios less than $10 million.

Fourth, with respect to the inclusion of any specific dollar-amount portfolio designation—$10 million in this instance—GFOA finds this criterion to be vague and difficult to apply. The following questions arise:

- In the context of a governmental unit, which portfolio would be considered when determining the size of the portfolio? For example, would all investments of a state or local government be considered a single portfolio, or would those managed by different state departments be considered separately? Would the pension funds of a city be deemed to be part of the portfolio of the city, or would the pension funds and the cash management funds of the city be considered separately in determining portfolio size? What about those jurisdictions that maintain separate pension funds, bond funds, and other funds? What about jurisdictions with multiple funds managed by different individuals, such as department heads?
- During what period does the $10 million portfolio size criterion apply? Does this amount refer to an average annual portfolio size, or would the suitability obligation change when a jurisdiction's portfolio reaches $10 million? This distinction is particularly important in the context of a governmental unit, because at any given time, even the smallest government may have a $10 million portfolio after a cash infusion resulting from bond proceeds or tax receipts. The more typical portfolio of that government, however, may be considerably less.
- How would a broker-dealer know whether or not a given jurisdiction had $10 million or more invested in securities during a specific period? How would the treatment of a jurisdiction with less than a $10 million portfolio differ from one with a portfolio greater than $10 million? What is the policy reason for treating a $9 million portfolio differently from a $10 million portfolio?

The suitability provision of H.R. 2131 seems at odds with efforts now being undertaken by many state legislatures in the wake of the Orange County bankruptcy and default to strengthen rather than weaken suitability standards. The State of Texas, for example, passed legislation earlier this year that would prohibit a jurisdiction from buying securities from a broker-dealer who has not received and reviewed the written investment policy of that governmental entity and acknowledged that it has implemented reasonable procedures to preclude "imprudent investment activities" arising out of its investment transactions. Similar legislation is pending in Ohio. Other states, such as Connecticut, have written such a procedure into their investment policies.

Finally, we also share the concern of the SEC and others regarding the potential impact of this provision's legal presumption on SEC Rule 10b-5 actions. By writing a nearly irrebuttable presumption into the 1934 Act, it could almost certainly be raised as an affirmative defense to liability in *any* action against a broker-dealer involving investment losses.

CONCLUSION

GFOA believes that the suitability provision contained in H.R. 2131 improperly shifts the burden of evaluating investment alternatives entirely to the institutional investor and that this provision is ill-advised. Rather than encourage the parties to clarify their relationship, we fear that H.R. 2131 will instead provide a means by which less diligent broker-dealers can avoid their legitimate and well-established responsibility to know their clients and consider their particular circumstances, and that this could lead to further state and local taxpayer losses.

GFOA believes that the proposed NASD rule strikes the right balance in acknowledging the need for public investors to receive recommendations for suitable investment instruments while recognizing that public investors are responsible for their own investment decisions once they are provided with appropriate recommendations. It properly considers both broker-dealers and public investors to be professionals, each with their own roles to play in the investment process. This rule should be given an opportunity to be adopted and implemented before a significant change such as that contained in H.R. 2131 is enacted. We hope you will consider our views carefully before approving such a provision.

Mr. FIELDS. Let me just ask very quickly, has Mr. Edward Fleischman come into the room?

Mr. Saladino, let me ask very quickly, and also make one quick statement, that if fault is involved, the suitability provisions of our bill do not come into play. The question I was going to ask, though, is, you are an attorney and I would assume that, you know, most of your members either are attorneys or are represented by counsel. Why couldn't you and your colleagues draft an agreement as to what the suitability obligations are?

Mr. SALADINO. Well, Congressman, it is interesting you should ask that question because we have tried to do just that. In our jurisdiction and in many others, there are adopted investment guidelines.

Four years ago, GFOA undertook a project to develop guidelines for jurisdictions, particularly smaller unsophisticated jurisdictions, to deal with broker/dealers, as part of that effort we developed a model contract between a broker/dealer and a local government. PSA, the Public Securities Association, who you heard from earlier today, was directly involved in that process with us. And at every step of the way, they refused to put any provision in a model contract which would even acknowledge that the broker/dealer had received investment guidelines.

What we kept hearing from them was they don't want to know our investment guidelines because then they have a duty to monitor compliance, which is not what we argued. In fact, we tried to put that in the contract.

So I think when people argue that the simple way around this is to, by contract, put the burden on the broker/dealer, our experience is that there is not a single broker/dealer who will agree to such a provision.

Mr. FIELDS. In your guidelines, did you put the goals, the investment goals, in a particular entity?

Mr. SALADINO. There have been a number of cash management projects by GFOA which talk about prudent cash management techniques and investment guidelines, in fact, model investment guidelines, that can be used by jurisdictions that don't have access to any models on which to base their guidelines.

Mr. FIELDS. Did you also disclose what was in your portfolio?

Mr. SALADINO. In the Los Angeles County case?

Mr. FIELDS. Not your particular case. But it seems to me that one of the things that is essential, if you are going to talk about suitability, is for someone to know what the investment strategy or goals are, as well as what—you know, the entity at a particular moment is involved with, and it also seems to me that there would be a need for a continuing disclosure.

Mr. SALADINO. Absolutely. I think to a certain extent there may be a difference between corporate institutional investors and governments. Most governments are subject to public records acts which make all their investments a matter of public record. As a matter of policy in Los Angeles County, we disclose all of our investments specifically on a monthly basis.

Again, our experience has been that broker/dealers simply don't want to know, because they have expressed to us a concern that if they are given copies of our investment guidelines and if they

have detailed information about the portfolios of their particular clients, then somehow that will put a duty on them to make sure that the client doesn't invest in something that doesn't comply with that. But I think that goes far beyond what suitability requires.

Mr. FIELDS. Mr. Harris, let me turn to you very quickly and say how much I appreciate the constructive dialog that has been initiated. You stated that there is a compelling and demonstrated public interest in avoiding the rampant fraud that would otherwise flourish without State oversight of what are almost exclusively smaller unseasoned issuers who are not or cannot obtain listing on major exchanges. So by making that statement, are you saying that the most important function of blue sky laws is to protect against fraud?

Mr. HARRIS. Mr. Chairman, I have always regarded all securities laws, whether they be State or Federal, as an effort to protect investors in such a way that they have enough confidence to take the chance of making an investment in something which is quite intangible. Obviously, fraud is certainly part of that.

Investors are not willing—they may be willing to lose money on their investment, but they are not willing to find out that the market was rigged and that the deal was crooked.

So absolutely, fraud is—avoiding fraud, repressing fraud and punishing fraud is certainly a very important part of State and Federal securities regulation. Whether or not it is the single most important thing, it is hard to say, sir.

Mr. FIELDS. Well, the reason I ask, in both your 1994 and 1995 annual survey that you conducted regarding investor complaints involving investment company products, that is—those studies indicated that the large majority of those complaints involved sales practices and that those complaints far outnumbered complaints relating to disclosure or other matters relating to registration.

Mr. HARRIS. I think it is certainly true that a large percentage of all—of all enforcement cases do relate to sales practices. But that is not by any means to say that there are not important enforcement cases which don't relate to lack of disclosure on other issues, as you mentioned.

Mr. FIELDS. Well, let me ask you in a little bit different way. Can you think of ways in which the resources the States are currently spending on reviewing registration statements might be appropriately reallocated toward enforcing against and prosecuting fraudulent behavior of the agents who sell the securities?

Mr. HARRIS. I think that the review of the registration, the State registration of securities offerings, is one component of the total investor protection effort. Take that away and let the States wait around for the telephone to ring and receive a complaint and then go and do an investigation after the fact, I think it makes the system much less effective.

Mr. FIELDS. Okay. Thank you.

The Chair's time has expired.

The gentleman from Pennsylvania, Mr. Klink.

Mr. KLINK. I thank the Chairman.

Mr. Harris, if I understand, you seem to be suggesting that the SEC should retain oversight over the large offerings and the States should take—be more concerned about the smaller, riskier

handlings like penny stocks and limited partnerships. Is this, do you think, a basis for a compromise between Federal and State regulators?

Mr. HARRIS. Congressman, that is basically the current system. The current system, as I think you know, provides that in the case of equity offerings of corporate securities, that the larger offerings and even medium-sized offerings are basically exempt because they are listed on either the national market system or they are listed on the exchange.

The States retain jurisdiction in the areas of smaller offerings, which are usually localized offerings. Quite often they are localized offerings. They are quite often under $15 million or even under $10 million. The States also retain jurisdiction with respect to limited partnerships, an area in which there has—we can take note of the fact that there have been many problems in the last few years, and with respect to investment companies.

As I have indicated, we are open to a discussion about whether or not investment companies, which truly are national offerings, ought to continue to be reviewed at the State level.

Mr. KLINK. Could you—were you in the room when Mr. Sargent testified, on the panel before you?

Mr. HARRIS. Yes, sir.

Mr. KLINK. Could you comment, if you would, on Mr. Sargent's contention that by eliminating State review of mutual funds you eliminate most of the problem.

Mr. HARRIS. Well, I—I would tend to agree that investment companies are the principal national offering that continues to be reviewed at the State level, such to the extent that the Pennsylvania numbers, by the way, related only to corporate offerings, and it showed that of the corporate offerings that were sold in Pennsylvania, only 5 percent were not exempt at the State level. But, obviously, there is another category of offerings, and that is investment companies, and so to the extent that that is addressed, you are talking about virtually all the national offerings; yes, sir.

Mr. KLINK. Mr. Saladino, the accusation was made a little earlier that institutional investors are abusing the suitability rules by using them to make brokers the guarantor of the investments. How do you respond to those accusations?

Mr. SALADINO. Well, Congressman, I think that is just absurd. I think it has been pointed out through the course of this hearing today and at prior hearings, that there are no cases in which the suitability rules, which are basically just know-your-customer rules, have ever been used to impose liability against a broker/dealer.

We all know about the large investment losses of certain jurisdictions that have been in the news within the last 10 to 15 years, and in every one of those cases, there was either fraud or a breach of fiduciary duty under State law. I don't know of a single instance in which a broker was charged with liability simply because he tried to peddle something that wasn't appropriate.

Mr. KLINK. To follow-up, Mr. Saladino, the PSA witness that we heard from earlier today said that if institutional investors want suitability protections, that they will be free under the bill to contract with a broker to receive suitability protections.

My questions are: Do you see a problem with this? What happens, for example, if brokers merely refuse to enter into such a contract?

What happens if the only brokers willing to sign such a contract charge the institution an extra premium? Will the institutions end up paying more for protections that they are now guaranteed today as a matter of law?

Mr. SALADINO. Yes, certainly they would be paying more for protections that they are guaranteed now as a matter of law.

I would also like to say that it is extremely disingenuous of PSA of all organizations to be claiming that all you have to do is contract around this problem. In 1991, when we developed our model broker/dealer contract, PSA specifically refused to sign off for its membership on any contract which even acknowledged that the broker/dealer had received investment guidelines. They are affirmatively refusing to know their customers. And so I really don't see that there are any firms that would be willing to enter into contracts like that.

What they would probably try to do is to turn it into a financial advisory contract at a much greater expense, which is an enormous burden for a small jurisdiction. These contracts can run $100,000 a year quite easily.

Mr. KLINK. In regard to suitability, would it be your recommendation that we drop this provision from the bill and let the NASD suitability rule and institutional investors interpretation go into effect?

Mr. SALADINO. We believe it should be dropped from the bill. We have a few problems with the NASD rule as proposed, but we think that can be worked out in the rulemaking process at the SEC.

There are some alternatives, though. If the committee, or if the House as a whole, or the Congress, feels that it is important to address suitability in some way, as I said in my prepared testimony, I think that it might be possible to allow broker/dealers to affirmatively defend themselves by claiming that the investor, in fact, was sophisticated, and they can prove that in the usual ways that things are proven.

Mr. KLINK. Mr. Harris, do you have any comment about that, any feelings about the suitability rules and what might—what you would suggest be done in this bill?

Mr. HARRIS. Congressman, I have concentrated so much on Section 3, which relates to the States, that I haven't really.

Mr. KLINK. Let me ask you very quickly, Mr. Harris, on page 16 of your testimony, you state that one third of the securities offerings subject to State merit review had serious regulatory problems, such as an accountant's opinion that there was substantial doubt about the company's ability to continue as a going concern. What would happen if these offerings weren't reviewed by the States?

Mr. HARRIS. If these offerings were not reviewed by the States, in many cases, they would go effective in the State and be sold without adequate disclosure.

Mr. KLINK. Mr. Chairman, I yield back the remainder or of my time.

Mr. FIELDS. Mr. Harris, in your task force, do you have the objective of making a recommendation to Congress or to the Securities and Exchange Commission? And if you do, what is your timetable?

Mr. HARRIS. The answer to the first question is, yes; the answer to the second question is, as quickly as possible. We have asked the task force to conclude its work by April. It may be that some aspects of the work could be done more quickly.

Unfortunately, the people involved, because they are distinguished, are very busy and so it is hard to hold them all together for long periods of time, but we are working as quickly as we can, sir.

Mr. FIELDS. We appreciate that.

The Chair again would like to thank our witnesses for participating and giving us your insight.

And this hearing is adjourned.

[Whereupon, at 1:10 p.m., the subcommittee was adjourned.]

[Additional material submitted for the record follows:]

PREPARED STATEMENT OF EDWARD H. FLEISCHMAN, CONSULTANT, LINKLATERS & PAINES

Mr. Chairman and Honorable Members of the Subcommittee: The very first sentence of the Constitution vests in you and your House and Senate colleagues the authority and responsibility to legislate, that is, to make the laws you think necessary and proper for carrying into execution the powers granted under the Constitution to the Federal Government. Yours is an ever-renewed task. The conclusions you reach today will call for re-visiting tomorrow, whether for confirmation that they are still valid to address the perceived legislative need or for reevaluation in light of better understanding either of the need itself or of the costs imposed by the chosen legislative solution. The introduction of H.R. 2131 and this hearing today evidence just such a re-visiting, and I am honored that you have invited me to participate by testimony.

In the spring of 1933 and through the next year, the House Committee on Interstate and Foreign Commerce took the lead in constructing the key pieces of legislation that would respond to what the Committee described as "the wanton misdirection of the capital resources of the Nation" and that would prescribe a regime based on "honesty, care and competence" for regulating interstate transactions in investment securities during the ensuing decades. At that time it was assumed that government mandates were essential to the redirection of the nation's capital resources, and that honesty, care and competence depended on government-prescribed command-and-control rules. At that time it was assumed that the ocean's distance separating the United States from those foreign markets that had managed to survive war, inflation and depression permitted the U.S. to establish a market regulatory system in isolation from market activity anywhere offshore. And at that time it was assumed that independent (so-called "fourth branch") devotion to vindication of "the public interest and the protection of investors", overseen by all three of the constitutional branches, would produce regulatory results objectively optimal for the markets, market participants and the public at large. Based on those assumptions, the United States has developed the most encompassing securities market regulatory structure in the industrial world, *and* it enjoys markets that are often acclaimed as the most liquid, the fairest and the most efficient markets anywhere.

Why re-visit success? Why tamper with what's working? Because of one theme of the Report of the Commerce Committee accompanying the bill that became the Securities Act of 1933, a theme that was initially quoted in the President's Message and then set out as a standard for judging the Committee's work: "the protection of the public should be achieved with the least possible interference to honest business." It's now long past time to reconsider whether the depth and fairness and efficiency of our markets garner more protection or suffer more interference from a system of one-size-fits-all regulatory mandates and command-and-control prescriptions. It's also long past time to reevaluate whether the strength and attraction of our markets are more augmented or more debilitated by a systematic insistence that the U.S. regulatory prescriptions, alone in the developed and emerging market world, achieve fairness for investors in securities offerings and securities trading. And finally it's long past time to reassess whether the investors, issuers and

intermediaries (any or all of them) in our markets reap greater benefit or incur greater cost under an administrative regime characterized by what now-Justice Breyer once described as "an agency's conscientious performance effectively carr[ying] the single-minded pursuit of goal too far, to the point that it brings about more havoc than good".

In a world in which instantaneous telecommunication of information spreads increasing efficiency among markets and market intermediaries worldwide, in which an incalculable multitude of differently-motivated investors, traders, hedgers and speculators participates in competing markets for ultimately-suitable financial instruments, and in which markets bear less similarity to the market world of the early 1930s than the early 1930s world bore to the world of the Hanseatic League, I do believe that increased understanding of how markets function will lead you to legislative responses, directed to the challenges of the 1990s and beyond, that are substantially more cost-sensitive, more performance-driven and more market-oriented than have been the responses directed to the failures of the 1920s, the 1960s and the 1980s.

That seems to me to be the direction to which H.R. 2131 points, and I, for one, welcome it. The plotting of the course is, however, far too complex for any one commentator to accomplish in any single sitting. So, with your permission, I shall devote the first part of my testimony to suggestions provoked by just a few of the provisions of H.R. 2131, and then go on from there to certain suggestions complementary to those provisions.

(I) Exemptive Authority.

Section 7 of H.R. 2131 would give the Securities and Exchange Commission broad authority to exempt securities from the registration requirements of the Securities Act. Both the Investment Company Act and the Investment Advisers Act vest similar exemptive authority in the Commission. At present, however, the Securities Act specifies only two areas for exemptive rulemaking: securities issuances of $5,000,000 or less, and securities issuances by small business investment companies. The Securities Exchange Act similarly bestows no general exemptive authority, permitting exemption only in a variety of discrete contexts or where the statutory language prohibits conduct "in contravention of such rules and regulations as the Commission may prescribe".

Broad exemptive authority is necessary for the Commission to be able to adapt administration of the law to the evolution of markets and market instruments. Whether for flexibility in recognizing the legitimacy of transactions for which staff advice that "no enforcement action will be recommended" is the only currently available permissive tool, or in clarifying that non-fraudulent market practices may be defined out of the purview of "offers", or in providing assurance that newly developed financial instruments lack the economic characteristics of "securities" and will not be regulated as such, exemptive authority can be vitally useful both to the regulatory agency and to the marketplace. But it is extraordinarily important that you make clear to the Commission *your intention* that its exemptive discretion not be inhibited by the very mandates from which relief is required.

Too often, under those statutes which do grant the Commission broad exemptive rulemaking authority, the Commission has been reluctant to exercise that authority except (as phrased in 1941) for "special situations that might have been overlooked or that could not be foreseen at the time the [particular statute] was drafted". However appropriate that attitude may have been in the years shortly after the National Industrial Recovery Act was voided by the Supreme Court, the Commission should have no more reluctance to exercise exemptive rulemaking authority conferred by the statutes it administers than to exercise the inclusive or extensive rulemaking authority so conferred—and in your Committee Report *you should tell it so.*

(II) Promotion of Efficiency, Competition and Capital Formation.

Section 8 of H.R. 2131 would direct the Commission to consider or determine whether its actions will promote efficiency, competition and capital formation whenever it is otherwise directed to consider or determine consistency with the public interest or the protection of investors. Recognition that investor protection is a necessary but by itself not a sufficient condition for vindication of the public interest in market regulation has the potential to evoke substantial change in certain long-intractable areas of regulatory policy.

Capital formation for entrepreneurial business is one such area. The high risk associated with investment in entrepreneurial business as a class inevitably leads to proportionately greater investor losses than are incurred by investment in established business. The very notion of "materiality" as a standard for law violation weighs far more heavily on entrepreneurial business than on established business,

so the burden of a unitary mandated disclosure system directed single-mindedly to assure investor protection handicaps entrepreneurial business whether in public or private financing. Elevation of competition and capital formation to an equal or near-equal footing with investor protection can be expected to direct regulatory policymakers to consideration of non-conventional means of reconciling these often-conflicting values: the possibilities inherent in investor mutual insurance devices, in opt-in risk assumption schemes, and in exclusion of protection of investments below a minimal dollars-per-investor amount, all come quickly to mind. So do institutional- purchaser-only systems, although these latter suffer from the defect of shutting out many individuals quite willing and able to "fend for themselves". Whatever emerges cannot be more costly or stultifying to entrepreneurial business, and thus to the public interest, than the present statutory scheme as presently administered.

Investment in securities of foreign companies is another such area. The strong reluctance of many foreign companies to disclose in the United States more than is required by their home country regulator or home country stock exchange, where the most liquid trading in their securities occurs, has kept these companies off the electronic trading screen and relegated quotation of their securities to the "pink sheets" as if the year was still 1975. Elevation of competition and efficiency to consideration along with investor protection can be expected to provide market regulators with a rationale for upgrading the NASD's electronic bulletin board or for accepting alternative electronic vehicles for the U.S. publication of quotations and the U.S. execution of trades in these securities—securities whose prices are not established here but are admittedly derived in U.S. trading from the prices prevailing in their home country markets.

Both these examples suggest that, within the purview of the federal securities regulatory scheme, there could easily be more than one disclosure pattern—as there could be more than one materiality standard. Nearly 20 years ago a critic of the unitary mandatory disclosure system pointed out that market-driven (i.e., negotiated) patterns of disclosure do exist side by side with the administratively mandated pattern, in the niches created by the various exemptions from the registration requirements of the Securities Act and the Exchange Act. Despite the pressures for uniformity exerted by civil litigation and administrative enforcement, those market-driven patterns persist in varying degree to the present day.

Suppliers of capital, market analysts and trading market participants continue to elicit information that they deem necessary for lending, investing and trading decisions. Ironically, despite the extent to which macroeconomic information, industry comparison, and estimates of future results form the true grist for lenders', investors', traders' and analysts' decisions, those categories of information are omitted from the compulsory canon as unreliable and therefore counterproductive to investor protection. Issuers nevertheless supply that information regardless of administrative mandate because the alternative is to foreign access to the capital markets. (I am indebted to the late Prof. Homer Kripke for his insistence on this key matter.) It is true that in the present administrative system investors have the benefit of a great deal of additional mandated data, but the cost of administrative compulsion lies right there in the mass of disclosure required of all public companies in the name of investor protection, whether or not germane to achieving market access or otherwise utile to the marketplace. Section 8 of H.R. 2131 has the potential to alter that compulsion and moderate that cost.

(III) Federal/State Issues

Section 3 of H.R. 2131 would preempt, in varying degrees, state law relating to registration or qualification of securities, registration or licensing of broker-dealers and their associated personnel, regulation of investment companies and regulation of investment advisers. In a speech last month to the State Securities Regulators (and in his testimony to this Subcommittee last week), S.E.C. Chairman Levitt seemed to concur with this Section to the extent that it relates to investment companies but suggested that the federal government defer to the states with respect to the smaller investment advisers. I agree that regulation of the smaller advisers (wherever, in terms of assets in custody or assets under management, the distinction of "smaller" may best be drawn) should rest exclusively with the states. The bulk of those advisers' clients tend to be located in one or a few contiguous states; the law governing their relationship to their clients is state fiduciary law; and there is much to gain, and comparatively little by way of cost incurred, from the existence of varying state regulatory regimes. One would think this a particularly apt arena for the states to serve as regulatory laboratories but, unhappily, from the time when exemption of smaller advisers at the federal level was first proposed (*circa* 1988) the state regulators have resisted the *responsibility* that would come with federal with-

drawal. That resistance to visible (and sole) state responsibility for regulating the smaller investment advisers belies many of the arguments made in opposition to federal preemption with respect to securities qualification and broker-dealer licensing.

The burden of "blue sky" regulation is heavy indeed with respect to qualification of securities offered by small business enterprises across these United States. For many years the dream of relief from that burden was an annual subject of discussion at the Government-Business Forum on Small Business Capital Formation convened by the S.E.C. pursuant to the 1980 amendments to the Securities Act, but not until introduction of H.R. 2131 has there ever been any prospect for realization of that dream. Multiple filings, multiple reviews, multiple interpretations of merit review policies, the requirement to report each rejection (and the reasons for rejection) to every other reviewer—all combine to make multiple qualification arduous and costly for that category of enterprises least able to spare any substantial portion of the capital proposed to be raised. In fairness, the rationalization for this regulatory steeplechase has been the greater risk inherent in small businesses well as the greater susceptibility of "thin" small business issues to manipulation by scam artists. But the immediate past chairman of NASAA, at a small business capital formation conference held earlier this year, pointed out the fallacy of believing that merit regulation is the appropriate vaccine:

> "We have to learn from the painful lessons of the penny stock era and grow a legitimate market. There wasn't much on paper that mandated the penny market had to be dirty, it just was.... Perhaps brokerage firms would have to apply for a new kind of license or qualification process to underwrite and make a market in this class of small business issue. We could develop a more precise, specific rule and calculation for mark-ups in this special tier market. Participants would agree to a maximum spread between bid and asked.... What if the trade-offs included... last trade quotations with mandatory reporting by market makers, and most importantly, an exemption form or relaxation of the 'cold call' rule? I'm not a market economist, but I have to believe an experimental marketplace could be developed, without the frauds given realistic incentives."

In other words: state merit regulation having failed to prevent rip-offs, the next effort ought to be full disclosure, along the lines of the federal model, coupled with state expectation as to after-market dealer practices. The provisions of, and exclusionary authority created by, Sections 3(a) and (b) of H.R. 3121 lend themselves easily to just such an effort. *And* I am delighted to draw to the attention of the Subcommittee the follow-on research endeavors that should buttress the positions embodied in Section 3. That research, being undertaken through the facilities of the Haas School of Business at the University of California, Berkeley, includes identification of the data needed by legislators for this purpose, examination of regulatory impact and of the effect of change from merit review to full disclosure, empirical determination of the incidence and extent (in California) of "fraud", comparison of "fraud" and "foolishness", establishment of the incentives needed to bring intermediaries into this market tier, measurement of the economic benefits of creating public markets for emerging enterprises, and analysis of the balance of interests among entrepreneurs, intermediaries, investors, regulators, legislators and the public at large.

The burden of "blue sky" regulation can be similarly heavy with respect to licensing and registration of broker-dealers and their associated personnel. You have already received testimony on this point from Saul Cohen, Esq., of New York, and I need not repeat that testimony today. Accepting the validity of the several states' need to require and to withdraw licensure, it remains true that divergence from the federal standards governing registration, capital requirements and recordkeeping by broker-dealers holds Congressionally-determined or Congressionally-sanctioned requirements hostage to local gaming, and imposes a cost upon the entire U.S. system for delivery of securities-related services as a result of the practical impetus of multistate firms to apply the highest common denominator of regulatory demand to their regional and national operations. Ironically, of course, that cost is ultimately borne in large part by customers in states that conform to the national norm.

(IV) Margin Regulation.

Section 4 of H.R. 2131 would eliminate margin regulation on other-than-equity securities, and would exempt from margin regulation a variety of "institutional" accounts. Whatever may in 1934 have been the expectation for governmental prescription of margin levels to affect market activity, for nearly twenty years now (as a result of two in-depth staff studies) the Board of Governors of the Federal Reserve System has doubted the effectiveness of using margin as a tool to combat the evils

of "speculation". Viewed in light of those studies, this portion of Section 4 is a long-overdue step toward refocusing margin regulation away from impact on market activity and back to protection of market intermediaries, away from governmental prescription and back to administration by self-regulatory organizations, with ultimate intervention authority reserved to the Board of Governors if ever necessary to deal with "substantial instability in the financial markets"—which is, in my view, exactly where margin regulation belongs.

(V) Regulatory Flexibility, and Command-and-Control Rules

"[R]ules of uniform application impose unnecessary and inequitable requirements on individuals, small businesses, small organizations, and small governmental jurisdictions.... [R]easonable alternative rules could be developed which would minimize the adverse economic effects on individuals and small entities subject to those rules and regulations without a significant loss of regulatory efficiency...." That quotation, from the Senate Committee Report accompanying the Regulatory Flexibility Act, bespeaks a truism (as to the impact of one-size-fits-all regulatory mandates) and a judgment (as to the ability to regulate with discrimination and still to regulate effectively) that have, in the intervening 15 years, been all but ignored in U.S. market regulation. True, there have been successive "small business initiatives", but restating detailed regulatory requirements in more comprehensible language and extending relief from the necessity of compliance with the outermost crust of regulation without examining the burdens imposed by the layer upon layer of regulation that lies beneath fall far short of a real balancing of costs and benefits, not to speak of a set of "reasonable alternative rules".

I have already in this testimony referred to the effect of the concept of "materiality" as a standard for law violation. With your permission, I'll expand for a moment upon that theme. "Material facts" and "omission to state material facts" (what President Roosevelt in 1933 called heavy: lengthy and detailed rules evoke lengthy and detailed procedures for compliance, and lengthy and detailed correspondence in interpretation. What is achieved is certainty of compliance for the particular proportion of market transactions that has no deviance from the detailed provisions of the rule; what is lost is the market function (unless and until staff blessing is obtained) of the correlatively large proportion of transactions that deviate in however immaterial a manner—and also the energy, time and money expended to achieve that staff blessing. Across the ocean, Lloyd's of London announced three months ago that it expected to move toward "a system of advising on 'best practice' rather than a prescriptive system requiring a complex rule book". H.R. 2131, by articulating this Subcommittee's understanding that it *is* possible (in fact, not only possible but quite feasible) to design performance standards that implement the administrative goals of the federal securities laws, could take the lead in moving U.S. market regulation in the same direction, without the occasion of the disaster that has befallen Lloyd's.

(VI) Cross-Border Practices.

For the 25 year's prior to 1990, U.S. market regulator's were insistent that they alone could protect Americans, wherever in the world Americans happened to be, against non-disclosure and fraud in securities transactions. Only then did the regulators acknowledge that the securities markets in London, Paris, Amsterdam, as well as Tokyo, Hong Kong, Singapore and elsewhere, are themselves conducted under regulatory regimes designed to assure—and in fact achieving—marketplace integrity and investor protection, although relying on rules of the local securities road different from those in place in the United States. Only then did the regulators acknowledge that the foreign regimes afford equivalent and appropriate protection to Americans deliberately travelling abroad for transactions in investment securities. Despite that acknowledgment, however, U.S. market regulation persists in the belief that the rules of our domestic securities road are in fact the *ne plus ultra* of the securities world—that everyone else in every other country would be well advised to drive the way we do and that, as we do on our highways, we will enforce our practices on any foreign market participant coming to use our markets. In fairness, there is a comforting logic to equality of treatment of both domestic and foreign market participants, and there is an understandable reluctance to relax already-accepted requirements for domestic issuers and intermediaries.

The problem here is not an inflexible regulatory consistency; the S.E.C. does make occasional (sometimes begrudging, sometimes surprisingly forward-looking) accommodation to differences in disclosure and accounting standards, to timing differences in offering procedures, and even to realities of cross-border money management, that would otherwise inhibit efficient functioning of the U.S. marketplace. The problem is rather a failure to see the regulatory forest for the trees: the financial world is mobile enough in the mid-1990s for trading to move easily to wherever in the

world transparency, efficiency and liquidity combine to provide the best markets for the instruments sought to be traded (please notice that that does not suggest a "race to the bottom"; the OECD concluded several years ago that, while unnecessary, regulation may drive market operations to external centers, reasonable supervision contributing to liquid and transparent markets can strengthen markets and actually attract market participation), and therefore fundamental to U.S. market regulatory policy should be the effort, in the face of the inertia of home-country market familiarity, to attract foreign securities, foreign intermediaries and foreign investors to participation in the U.S. markets. U.S. markets have all the necessary ingredients to compete successfully for order flow in virtually any financial instrument, whether basic or derivative, so long as regulator-imposed inhibitions do not artificially and unnecessarily constrain that competition. U.S. market regulatory policy ought to be actively searching for core commonalities (as the S.E.C. has recently begun to do with respect to certain of the International Accounting Standards) in order to find reasons for allowing, rather than for precluding, foreign securities and foreign intermediaries to participate in U.S. markets (both primary and secondary) and to appear in U.S. trading systems (both floor-based and screen-based). To whatever extent foreign participation can be brought to the U.S., to that same extent the essential values and market characteristics underlying the U.S. federal securities laws will be afforded the opportunity to prove their worth (or to require adaptation) in the open marketplace. H.R. 2131, by laying out this Subcommittee's direction of the long-range goal of U.S. market regulation in our ever-shrinking world, could provoke the regulatory outreach for what has proven itself abroad just as we have adopted the mute international signs for our highways—and with similar minimization of downside regulatory risk.

(VII) "Tunnel Vision".

So very much of what H.R. 2131 seeks to accomplish is dependent on implementation by the S.E.C. that it is incomplete to testify before you without speaking my own experience of the strengths and inhibitions of this "best of all federal independent regulatory agencies". That characterization is accurate (at least in the fond eyes of this once-Honorable former S.E.C. official), but it omits to state some (subjectively) "material" facts.

Fourth Branch agencies do fall prey to an inertia in programmatic assessment and regulatory direction: success, or at least lack of criticism, breeds continuation of policy regardless of change in the regulated universe, until that change has accumulated enough subsurface force to threaten an earthquake of change. After all, "the public interest and ... the protection of investors" are the same today as they were 10, 25 or 60 years ago, aren't they? No, I don't believe they are. And I am not particularly perspicacious in understanding that the world of markets is not the same today as it was even two or five years ago, when each member of this Subcommittee, and I, and most present officials of the market regulatory agencies, last learned our lessons about the operation of markets and about such ill-defined concepts as "investor confidence" and "systemic risk". On the rare occasions when I had the unofficial opportunity to discuss these matters with the former Chairmen of this Subcommittee and of its parent Committee, I remember introducing this very topic—so that my views on the matter should come as no surprise to the distinguished Minority Members.

A regulatory agency implementing Congressional policy needs the greatest degree of guidance that the responsible legislative authors can give it. Generalities merely confer on the agency the capability to exercise relatively non-accountable authority in pursuit of its own institutional notions of what's good for these United States. That's why I am so supportive of Section 8 of H.R. 2131; it's the first statement in many a year of what you, the elected and responsible representatives of the American public, understand to be the goals underlying all the detailed provisions of the federal securities laws. Agree or disagree, the S.E.C. and I and the American public are bound to respect you for making the statement and are bound to reach for those goals in administering, advising as to and investing under this statutory scheme.

A regulatory agency faced with Congressional initiative tends to respond instinctively that any statutory amendment will likely be constricting, will necessarily have unexpected and untoward effects, and would be better accomplished if left to the agency's flexibility, expertise and discretion. That may all be so, but it is a siren-song to defer and thereby to deflect Congressional attention from what Congress perceives to be a legislative problem. Delegation of discretionary authority is earned by exercise of other already-vested authority; recent conversion garners less credence than does long-established policy. As a very interested observer of the S.E.C., I am very encouraged by certain programs initiated within the last year: I look foreward to the results of the Chairman's initial "sunset" review of disclosure rules,

and to the possibilities of "company registration" re-unveiled in the proceedings of Commissioner Wallman's Advisory Committee, and to the concordat that may emerge from the Commission's "summit" conferences with the state securities administrators. But I wish they had all started earlier, and I wish there was less suspected in-house opposition, and I wish there was more faith in market solutions to market problems. And, in all honesty, I wish there was more support from those apparently fearful of the market freedom that some of these initiatives suggest. The recent appointment of an economist to the senior market regulatory staff position came at the cost of the loss of a knowledgeable and devoted public servant but does bode changes that raise great expectations among market observers. The economists on your respective staffs have probably already told you so. In all, this Subcommittee has embarked upon an exciting undertaking with these hearings on H.R. 2131, and should stay the course. Real legitimacy of decision in our Republic lies within the buildings on this Hill, not downtown.

Finally, the most costly of all administrative policies is what I have already quoted in now-Justice Breyer's definition (in a Securities Act context) of "tunnel vision". Remember with me, for just a moment, what we have all learned about business (and sometimes personal) achievements: once a goal is articulated (so goes the old saw), 5% of the effort is spent on the first 95% of the accomplishment, 95% of the effort is spent on the last 4 44/100% of the accomplishment, and the final 56/100ths of 1% is accomplished only by in fact breaking through to about 115% of the original goal. The same is true in the regulatory world. Market regulators, in particular, are driven to effectuate that last 56/100ths of 1% of accomplishment, and in so doing impose inhibitions upon the non-infringing conduct of regulated persons to an extent at least equal to 15% of the conduct sought to be regulated. Those inhibitions most often are imposed by the regulatory retention of uncertainty all along and into the sphere of non-violative conduct—to the point that Justice Breyer's description is validated and "conscientious performance effectively carries the single-minded pursuit of goal too far, ... bring[ing] about more havoc than good". In performing its oversight function, even more than in considering and reporting on H.R. 2131, this subcommittee has the rare opportunity of instructing the S.E.C. to take most seriously its mandate to assess expected and unintended regulatory costs as well as intended benefits, and to inscribe Justice Breyer's admonition deep into its institutional psyche—so that our national securities markets may continue to hold their pride of capital allocation even in times when the Dow-Jones Industrial Average ceases to rise nearly every day.

Prepared Statement of Douglas M. Loudon on Behalf of Investment Counsel Association of America, Inc.

Chairman Fields and members of the subcommittee, my name is Douglas M. Loudon and I serve as President of the Investment Counsel Association of America, Inc. (ICAA).

The ICAA, founded in 1937, is a national association of investment adviser firms. In the late 1930s the ICAA actively worked with the congress in drafting what became the Investment Advisers Act of 1940.

ICAA member firms together manage over $800 billion in client assets for over 80,000 institutional and individual clients. Located in most states, they range from firms managing $50 million to firms managing $90 billion. ICAA firms provide clients with continuous, professional, investment advice, free from conflict of interest. The ICAA's Standards of Practice emphasize independence in the investment decision, and member firms are generally compensated by fees based on client assets rather than commissions. The ICAA promotes the investment counsel profession, encourages its integrity and competence, and represents the profession to regulators and legislators.

My testimony is limited to Section 3(d) of H.R. 2131 which addresses the problem of overlapping state and federal regulation of investment advisers.

I. The Problem

Mr. Chairman and subcommittee members, things have changed since the adoption of the Investment Advisers Act of 1940: there are now 46 states with state laws regulating investment advisers instead of just 6 when the 1940 Act passed. This has created a system of overlapping and duplicative regulation for advisers.

A. Problem for Investment Advisers

The current duplicative system puts a burden on advisers engaged in interstate commerce. Almost all of our member firms, and probably most mid-size and large advisers in general, operate in a number of states. The requirement of registering the firm and many of the firm's professionals in a number of states, as well as monitoring differences in state laws and regulations, has developed into a cottage industry and resulted in significant additional expense and effort for firms that already registered with the SEC, already subject to all of the SEC regulations, and periodically (now every 4 to 6 years) inspected by the SEC.

One recent estimate suggested that an adviser with a nationwide business must deal with over 500 different registration-related forms. In some firms, there are one or more persons whose sole job it is to work on state registrations and requirements. The North American Securities Administrators Association has made some good efforts to standardize some of the registrations but significant uniformity is still perpetually a goal rather than reality and has been for a long time.

B. Problem for Investor Protection

In addition, what may be even worse than the paperwork and expense burdens placed on advisers is that the present overlapping regulatory systems diffuse accountability and responsibility among federal and state regulators, thus diluting rather than strengthening investor protection.

When responsibility is diffused among multiple entities, naturally, there is less accountability for any one of them. This subcommittee is well aware that the number of registered investment advisers has exploded in recent years: from 1980 to 1994, the number of investment advisers increased 517%, from 3,500 to 21,600. Similarly, assets under management increased 2,082%. This subcommittee is also aware that the SEC's resources to inspect advisers have not kept up with those increased numbers, and the SEC is now focusing their attention on the larger advisers. To my knowledge, state securities commissioners are not reporting any budgetary surpluses either. In any event, diffused and overlapping regulatory responsibilities combined with reduced regulatory resources is not a desirable situation.

II. THE SOLUTION

In past years, the ICAA supported earlier legislative proposals to strengthen the SEC's resources to inspect advisers. For various reasons those legislative proposals were never enacted. This year, the ICAA has supported adequate SEC appropriations in the congressional Appropriations committees. Consistent with this background, it must be concluded that a new approach by Congress is needed to reduce burdens on advisers and help accountability and investor protection.

The ICAA applauds the leadership of Chairman Fields and the other cosponsors of H.R. 2131 by addressing the problem of overlapping federal-state adviser regulation responsibilities in Section 3(d) of the bill. Without Section 3(d) of H.R. 2131, this process would not have started.

The ICAA likewise applauds the leadership of Chairman Levitt and the SEC, which in testimony presented to this committee just last week, also made a specific legislative recommendation addressing overlapping adviser regulation.

We are also pleased to note that NASAA has established a Task Force to examine the federal/state efforts in securities regulation and we hope that they will also conclude that a revamping of the regulation of investment advisers is desirable.

In view of the apparent consensus between the introducers of H.R. 2131 and the SEC to address the problem of overlapping federal/state regulation of advisers, and perhaps NASAA too, the ICAA feels that the present situation may be an unusual opportunity to address both the concerns of advisers and the concerns for investor protection.

Accordingly, the ICAA supports the SEC's specific adviser proposal submitted to this subcommittee last week in Chairman Levitt's testimony—that the states register and inspect advisers with assets under management below $5 million and the SEC inspect larger advisers. The ICAA believes that the SEC proposal is the basis for a very good solution. This approach addresses both the problem of undue burdens from duplicative regulation, as well as the problem of diffused responsibilities and accountability among regulators. Further, the proposal is realistic, because it provides important roles for both the SEC and the states, as well as acknowledging that the SEC simply does not have sufficient resources to do the whole job itself even if that is the desirable course. While the details of the proposal still need to be worked out the ICAA is pleased to endorse the concept of the SEC proposal.

Chairman Fields and members of the subcommittee, I appreciate being allowed to submit this testimony.

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